



Invesco Investment Insights

China A-share market to thrive on economic growth and market improvements

January 2019



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Key takeaways

- Market-structure improvements, better access and development of the asset-management sector to make investing in China A-shares easier.
- Active strategies, including quantitative investing, in the A-share market can help enhance returns, while local experts can advise on how to lower risks typically associated with A-share investing.
- Uncertainties remain for the A-share market, but long-term trends make it an attractive option as China seeks to come onto the world stage.

China A-shares have had a difficult few months. Investor sentiment was dampened by rocky trade relations with the US and a weaker renminbi amid a slowdown in China's economic growth. Some investors thought that China would not weather a full-blown trade war with the US well, as it sells more to the US than it purchases. This comes even as the Chinese government is trying to tackle its debt burden in the economy without hurting growth. As a result, Chinese stock markets slipped into bear-market territory since their high in January 2018.¹ This caused China to cede its four-year title as the world's second-largest stock market to Japan.²

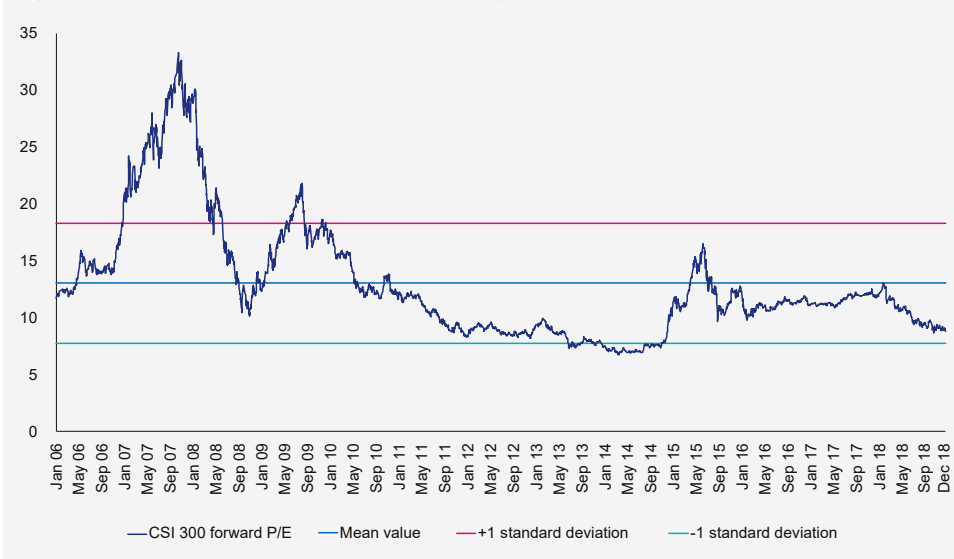
1. "From Shanghai to Frankfurt, these 8 stock indices are in bear markets", CNN, Dec. 21, 2018.

2. "Japan retakes title of second-largest stock market from China", Financial Times, Aug. 3, 2018.

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We think this is only a short-term disruption that in fact has made valuations very attractive for A-share investors to stay invested for the long term, with the benchmark index CSI 300's forward price-to-earnings ratio approaching its lowest level in four years (figure 1). Prospects remain bright for China's economy and corporate fundamentals, which could boost the long-term performance of A-shares. Investors looking to tap into China's growth should find it easier to assess, and to gain access to investment opportunities within the A-share universe.

Figure 1: CSI 300 forward price-to-earnings ratio hit four-year low in Dec 2018



Source: Wind Information, calculated by Invesco Great Wall as of Dec. 21, 2018.

China's growth trajectory will likely strengthen Chinese firms

China's economy is growing steadily and more importantly, the quality of growth is improving. The shift from an investment-driven model to a consumption- and services-led one should provide the economy with a balanced and sustainable growth trajectory, while efforts at deleveraging should put growth on a more solid footing.

This economic transition to consumption-led growth is expected to last several years, which in turn provides continuous support to China A-shares. There is still more room for private consumption to grow in China. In 2017, private consumption's share of China's GDP was at 39.1%, below the 68% in the US, 62.2% in India, and 55.8% in the European Union.³ We expect continued policy support from Beijing in promoting consumption as a key driver of economic growth. There are also government efforts at shoring up bad debt in the economy. For example, the government has introduced stricter rules and made it harder for weaker borrowers to refinance.

These parallel developments benefit mainland companies with better growth opportunities and firmer fundamentals. This in turn lends support to the performances of A-shares. More companies are now thriving in the new landscape, particularly the technology- and consumer-related ones.

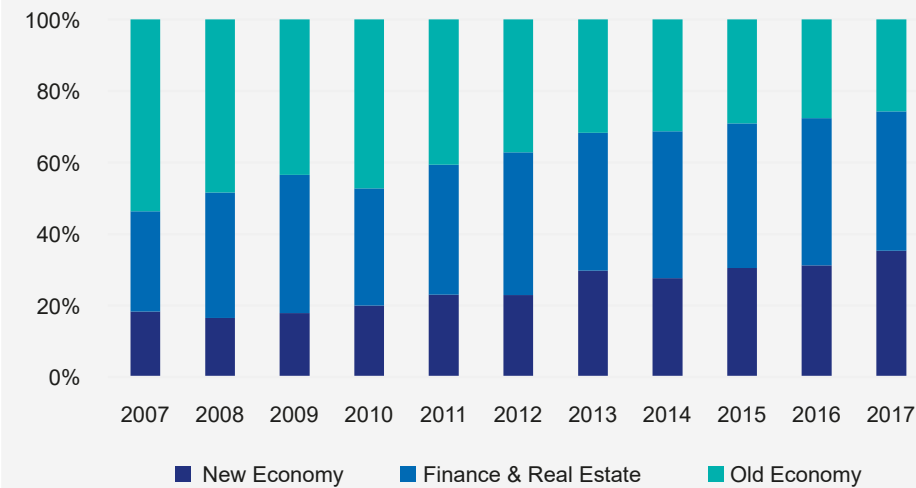
A-share indices are becoming more indicative of the underlying economy

At the same time, investors now find it easier to measure the performance of mainland companies against China's economic growth. The constituents of A-share indices have undergone structural changes, making the correlation between the asset class' performance and China's economic performance stronger, thereby increasing the attractiveness of A-shares to investors.

Take the benchmark CSI 300, for example, which is a capitalization-weighted stock index that tracks the performance of the top 300 stocks traded on the Shanghai and Shenzhen exchanges. In 2007, the weight of old-economy stocks covering materials, telecommunication services, utilities, energy and industrials sectors was at 53.6% - more than half of the index. That same year, new-economy names - those belonging to the consumer discretionary, consumer staples, and information technology sectors - represented only 18.4% of the index (figure 2).

3. Latest data for each country taken from CEIC as of January 2019.

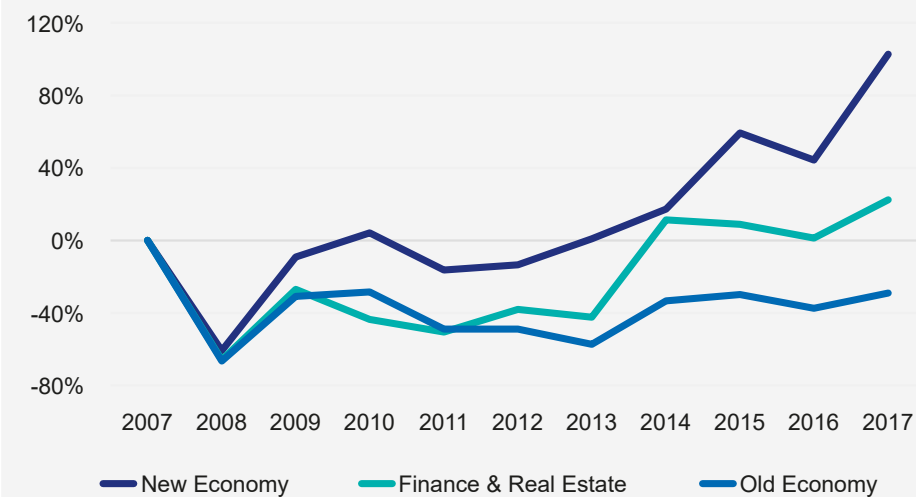
Figure 2: New economy takes up larger share on A-share benchmark



Source: Wind Information, calculated by Invesco Great Wall as of Nov. 19, 2018.

In the subsequent years, the old economy's representation on the index shrank, though still overshadowing the new economy for a good seven years until end 2014. During these seven years, old-economy sectors chalked up a negative 33% in cumulative returns, while new-economy stocks saw a 17% increase (figure 3). This meant that the overall CSI 300 was weighed down by old-economy sector performance and was disconnected from China's economic trends.

Figure 3: Old economy's cumulative returns fell

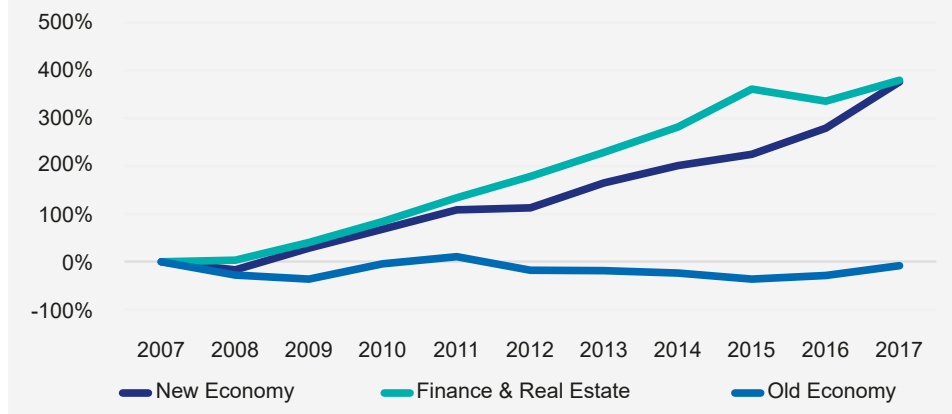


Source: Wind Information, calculated by Invesco Great Wall as of Nov. 19, 2018.

By the end of 2017, old-economy stocks only represented 25.7% of the index while new-economy stocks' weightage grew to 35.3%. Over the decade, old-economy names registered a fall of 29% in cumulative returns over the past decade, while new-economy stocks' returns grew by 103%. This increased representation on the index now more accurately reflects China's economic transition, where private consumption's share of GDP was at 39.1% as at end 2017.

It's worth bearing in mind that new-economy companies are also key beneficiaries of China's economic growth. Robust consumer demand and technological innovation are improving their bottom lines and driving returns, which then improve their fundamentals and benchmark returns. Our analysis shows that as at end 2017, the cumulative earnings growth of the new-economy sector was at 376% over ten years, while old-economy's growth fell by 2% (figure 4).

Figure 4: New economy registers good cumulative earnings growth



Source: Wind Information, calculated by Invesco Great Wall as of Nov. 19, 2018.

In fact, investors looking to ride on the growth in China's technology sector should soon find it easier to track technology stocks' performance. The technology-innovation board at the Shanghai Stock Exchange, seen as a Chinese version of Nasdaq, is expected to launch in mid-2019.⁴

It's worth noting that the benchmark CSI 300's disconnect from China's economic growth over the past ten years means that investors who know where to focus on within the A-share market would have been rewarded a lot more than if they had pursued passive-investing strategies.

Improved access to A-shares for offshore investors

China's equity markets are now more accessible to offshore investors than before. Over the past few years, Chinese authorities have been gradually relaxing restrictions to allow foreign investors to enter the market. We note that China's stock markets have been dominated by retail investors. These reforms mean that there will be more funds and a more diverse array of investors flowing into A-shares. The market will be less susceptible to the sentiment of a small pool of investors, thereby becoming more efficient.

The Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII) schemes are two of the earliest efforts, set up in 2002 and 2011 respectively, by China to internationalize its renminbi-denominated capital markets (table 1). Restrictions are in place for these two schemes, notably which institutions can qualify to participate and the investment products that are eligible for the regimes, so certain offshore investors may find it hard to access A-shares via these channels.

4. "China to Launch Nasdaq-Style Board in Shanghai", Caixin, Nov. 6, 2018.

Table 1: Differences between QFII, RQFII, Stock Connect (Northbound)

	QFII and RQFII	Stock Connect (Northbound)
Who qualifies?	Fund managers, insurance companies, pension funds, charities with an operating history of at least 2 years and AUM of at least US\$500mn.	No requirements on qualifications.
Any investment quota?	Total QFII Quota: US\$150bn; approved quota as of Nov. 2018: US\$100.6bn.	Daily northbound quota increased from RMB13 billion to 52 billion on May 1, 2018.
Who approves?	China Securities Regulatory Commission (CSRC) in charge of reviewing and approving qualifications; State Administration of Foreign Exchange (SAFE) in charge of reviewing and approving quota.	Any registered investor in HKEx (QFII investors must seek CSRC and SAFE approval)
What's the limit on shareholding?	A single foreign investor's shareholding ratio should not exceed 10% of the listed company's total shares. All foreign investors' shareholdings should not exceed 30% of the listed company's total shares (no limitation on strategic investors' shareholding ratio).	A single foreign investor's shareholding ratio should not exceed 10% of the listed company's total shares. All foreign investors' shareholdings should not exceed 30% of the listed company's total shares (no limitation on strategic investors' shareholding ratio).
Any limits on capital repatriation?	Abolished in June 2018.	Can repatriate in real time, more flexible than QFII (QFII investors need to open cash accounts at a domestic bank)
What investment products are eligible?	Common stocks, preferred stocks, bonds, funds, index futures, assets-backed securities, new share issuances, bond issuances, private placements and share allotments.	Only A shares.

Source: Hong Kong Stock Exchange. For illustrative purposes only.

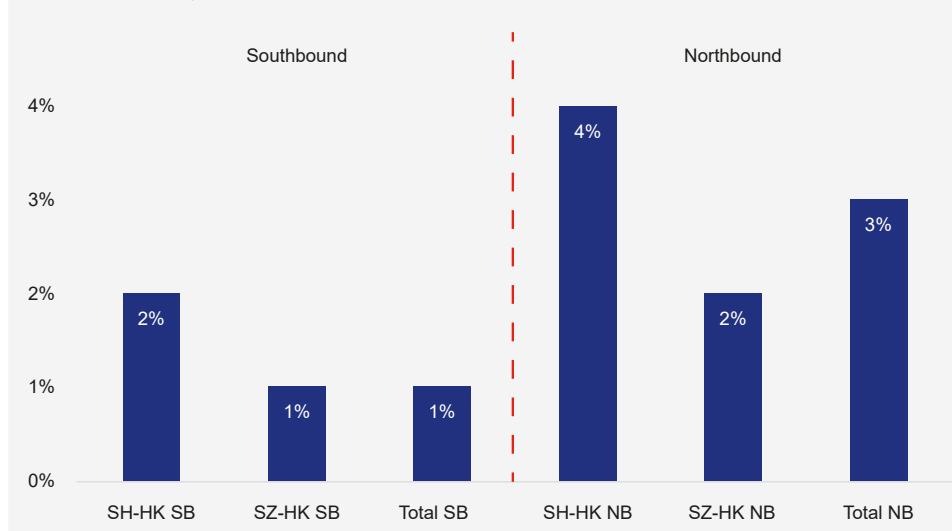
However, authorities recently eased restrictions on foreign fund manager outflows for these two schemes. They also removed lockup periods for investment principal, while qualified investors can now also hedge currency risk onshore. We believe these changes will make the QFII and RQFII schemes more liquid and transparent. These would increase the level of confidence offshore A-share investors have when investing via these channels.

Stock Connect, which started in 2014, is another channel for investors to access the A-share market. This is a two-way investment program between Hong Kong and the mainland's two main bourses in Shanghai and Shenzhen. Stock Connect allows repatriation of funds in real time, and we think this alleviates investors' concerns over capital controls. Stock Connect's structure also opens the asset class up to more investors, as it only requires that investors trading on Hong Kong's exchange can participate in the regime.

There have been concerns among global investors that daily quotas for funds flowing into China from Hong Kong under this program would be breached with each round of MSCI inclusion of A-shares into its indices, as passive exchange-traded funds would need to buy the shares to avoid tracking error. The quota has since been quadrupled to 52 billion yuan starting May 1, 2018.⁵ We think that this is more than enough for now, as data shows that only 3% of the daily northbound quota has been used on average (figure 5).

5. "China to sharply boost daily stock connect quotas from May 1", Reuters, April 11, 2018.

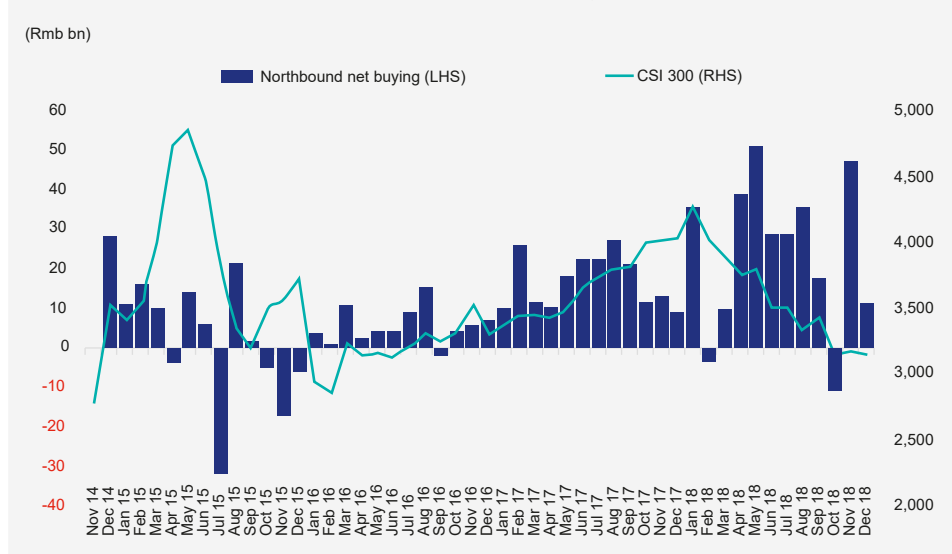
Figure 5: Stock Connect daily average quota usage remains low
 % of daily average quota used since the cap was quadrupled on May 1, 2018



Source: CICC, as of Jan. 7, 2019.

We think these changes are timely, as we believe interest in China A-shares will only grow from here onwards. Several major index providers have committed to adding A-shares to their indices, which would drive investors' interest in the asset class.⁶ MSCI began a two-step process to partially include A-shares in June and September 2018 and has said it may consider increasing their weight to at least 20% in the future. Data shows that there have been increased flows into Chinese markets via Stock Connect in the days leading up to the two phases of MSCI's inclusion in June and September 2018 (figure 6).

Figure 6: Stock Connect northbound flows higher before MSCI inclusion
 China A-shares added to MSCI index in June and September 2018



Source: CICC, as of Jan. 7, 2019.

The increased global interest in A-shares further reinforces the importance of Chinese equity investment strategies. A-shares will add to the depth of an investor's exposure to the Chinese market. They will also be more relevant to investors looking to tap into China's growth.

6. These include MSCI, FTSE Russell and S&P Dow Jones. Sourced from "S&P Dow Jones Indices to add China stocks to global indexes from Sept 2019", Reuters, Dec. 7, 2018.

Fundamentally-based active investing better at capturing A-share performance

Amid these structural adjustments, equity analysts and fund managers have been refining their approach to research on China A-shares. These efforts are expected to lead to an overall improvement in equity investment in China.

At the same time, corporate data and governance have been steadily improving over the past decade, which removes some level of uncertainty for fund managers. They now have a clearer picture of the risks and reward from holding a stock.

Yet, despite the many improvements on regulations, corporate governance and quality of financial data over the years, the China A-share market remains relatively more inefficient when compared to those in developed markets. At the same time, the mainland fund-management industry has been improving its active and quantitative strategies to capture better returns in A-shares. We see that a fundamentals-based approach to investing works for A-shares, just like elsewhere in the world, and active strategies ensure that investors can capture excess returns, or alpha, in the market. Of course, A-shares are still subject to high volatility and tracking error, but regardless of which approach (including active or quantitative strategies) investors or managers choose, we think that buying into companies that possess solid long-term fundamentals and can promise earnings growth at a cheaper price may help investors capture strong alpha in the China A-share market.

Intensifying competition within the industry also ensure that sell-side researchers and buy-side fund houses looking to beat the market will be attuned to producing better research and investing into better trading platforms.

Nascent market still presents risks

Yet, despite these general trends that are nurturing a more sophisticated Chinese A-share market, investors need to be mindful of some underlying risks.

It's important to remember that the market is young and there are still inefficiencies. For example, initial public offering (IPO) and delisting mechanisms for companies are not truly left to market forces. Best-performing firms in a given sector may not necessarily be able to enter or choose to enter the A-share market. Also, as noted above, the market remains sentiment-driven. Retail investors dominate the landscape. They may not apply the necessary analytical methodology to make long-term investment decisions. We, however, believe that this will change over time as Beijing liberalizes the market further. Pension reforms in China will also attract more institutional funds into the A-share market as more investment managers set up funds to help pensioners plan for retirement.

There are also regulatory risks. As we have seen in recent quarters, there have been many policy changes that have also been affecting the market. Beijing's recently announced changes to subsidies for new energy and electric cars and tighter regulations on pricing in the pharmaceuticals industry have all impacted share prices of car and drug makers. We view these shifts as beneficial to these companies, and by extension their share-price performance over long term, but they no doubt inject volatility to stock markets during the adjustment period.

That is not to say that investors cannot mitigate these risks. A good active manager that is familiar with China is crucial in serving as a local expert and partner and helping investors invest adroitly into A-shares. Investment managers that engage in deep research with presence on the ground can understand the market forces, industries and companies well, and therefore should make better investment decisions for investors. Investors need to be selective in finding the right managers to work with. This would be helpful in uncovering many opportunities to capture excess returns and overcome volatility and systemic risks, or beta, in the A-share market.

Conclusion

It has been almost three decades since the inception of Shanghai and Shenzhen's stock exchanges. During this time, market capitalization of the China A-share market has grown to US\$6.3 trillion - one of the largest in the world today.⁷

Going forward, there is room for the China A-share market to develop. The Chinese economy's transition towards high-quality growth, improving market structures and Beijing's policy approaches, including clearer regulations for companies, will ensure that more efficient and appealing companies join and excel within the A-share universe. We are convinced that Chinese equity markets will become more efficient over time, and in the meantime present ample opportunities.

Investors will now also find it easier to tap into A-shares than before. Beijing has shown commitment to liberalizing its financial and capital markets. There are now more means for investors to enter the A-share market. Market benchmarks, research and strategies are also improving so that there is a stronger correlation between market performance and underlying economic realities. Partnering with a good investment manager can help investors mitigate inherent risks in this young market.

Given the recent correction in A-shares, we believe they are now among the most valuable investable options globally. With structural and macroeconomic trends in their favor, China A-shares as an investable asset class is set to develop even further.

7. Source: Hong Kong Exchange, as of Dec. 31, 2018, retrieved on Jan. 2, 2019.

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