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Is it time to rethink China allocations?

Assessing near-term headwinds in a long-term story

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Investing for a world of change

We are an independent, active global asset manager dedicated to delivering compelling outcomes for our clients.

Since we started in '91 in an emerging market, we learned the importance of recognising and embracing change and uncertainty. It's taught us that active investing can be a force for good. It's also given us a different perspective on the issues that matter – from how we invest sustainably, to the major thematic and structural challenges facing

investors. Today we offer distinctive investment strategies spanning equities, fixed income, multi-asset and alternatives to help institutional investors, those advising others and individuals navigate an ever-changing world. Our corporate structure ensures employees are stakeholders in the firm and with our founding leadership still in place, we are well positioned to offer stability and a long-term outlook for our clients.

We focus on where we can make a real difference for our clients. We work with clients based all over the world who have entrusted us to manage £103.4 billion in assets (as at 31.03.20).

Investment involves risk; losses may be made.

fast

The fast view

- In 2019, we wrote extensively about China allocations, arguing that Chinese assets lacked the exposure across a typical portfolio that their sheer size – and potential risk-adjusted returns – justified. The coronavirus (COVID-19) pandemic has presented us with an opportunity to revisit the topic.
- China entered the recent crisis first – local state media refer to it as a 'closed-book exam,' and China has faced intense scrutiny regarding its handling of the pandemic, while many countries – faced with an 'open-book exam', - have sought to learn lessons from China in order to combat the disease in their own states. Especially close attention is being given to China's approach to restarting its economy and attempts to avoid a second wave of infections.

- These efforts are widespread and varied to account for local differences across both regions and industries. Having local expertise, analysts and portfolio managers on the ground in Hong Kong, has been a considerable help in accurately assessing what is occurring in real time. The picture painted by the on-the-ground insights is one of a country rebuilding with confidence and to such an extent that GDP growth for the year is forecast to be positive and exceeded expectations in the second quarter.

- E-commerce giants – which incidentally grew out of the last pandemic in 2003 – have been beneficiaries of this crisis, but during the rebuilding phase, the acceleration of future domestic reforms will lead to considerable investment in core infrastructure.
- Much of this transformation is needed in order to serve an ever-growing urban population, but also to alleviate poverty in the vast rural population, which is a core goal of the state's latest economic plan. While complex and sometimes unsavoury issues remain – the strained relationship between Hong Kong and Beijing has recently resurfaced after months of COVID-19 induced calm – it is important to view the investment potential of the country over a long-term horizon. The same can be said about the threats of US sanctions in an election year; both are near-term headwinds to an otherwise long-term story.

- The performance of Chinese equities this year is now showing double-digit growth, far outpacing the performance of global peers, including the US, Europe and Japan. Chinese fixed income markets also performed well, and when one considers this resilience against the backdrop of both Chinese equities and bonds having very low correlations with other major asset classes, the case for re-thinking allocations to China is further strengthened.

view

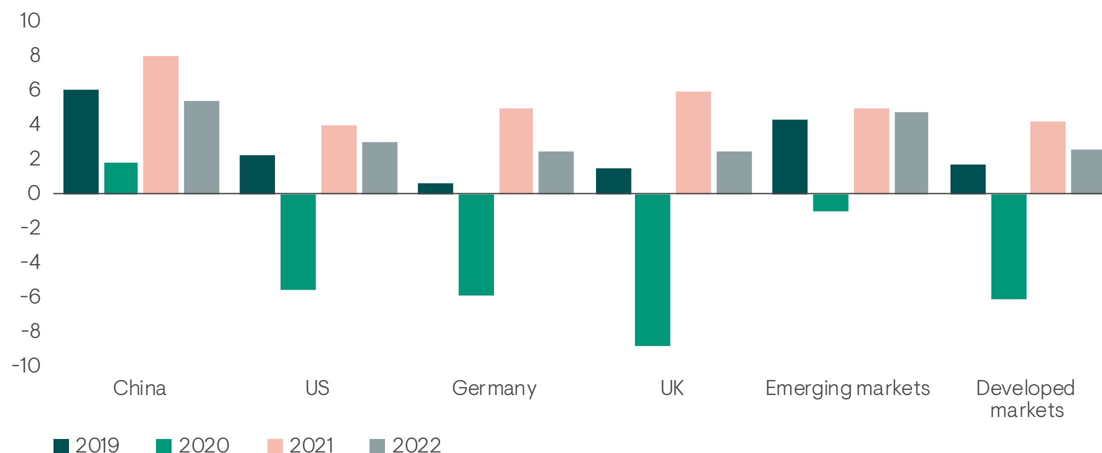
Restarting its economy – the world is watching

China is potentially staging a v-shaped recovery, and the world is watching. It was the first to experience disruption from COVID-19 and has also been the first to try and move past extensive and aggressive quarantine measures while managing the risk of a resurgence in cases. Flare-ups in cases, such as we have seen in Beijing, have been rapidly dealt with through lock downs and travel restrictions. Depending on the region, the process of lifting the lockdown restrictions has been quite different. Our analysts on the ground in Hong Kong, who are engaging with Chinese companies on their activities, point to the widespread impact across regions and sectors, ranging from spectacular drop-offs in activity, tailwinds behind e-commerce and digitalisation, a surprisingly quick restart to industrial production – and eventually for services – as well as increasing government support.

China suffered a growth shock, but the year still looks positive

China's economy shrank 6.8% in the first quarter of 2020 on an annualised basis, the first decline in four decades. In the second quarter, the economy grew by 3.2% outperforming expectations and signalling a potential v-shaped recovery. Current consensus estimates point to China's growth remaining in positive territory for the full year at 1.8%, which is then expected to accelerate to 8% in 2021. With the significant slowdown in the US during the second quarter, it is technically possible that for a single quarter China was the world's largest economy. Looking ahead, China is set to weather the fallout from COVID-19 better than developed markets, with our forecasts currently showing a far greater impact on growth for developed economies.

Figure 1: China's economic growth is expected to remain positive, and continue outperforming developed markets



Source: Ninety One, Bloomberg as at July 2020

China's growth trajectory is also set against a relatively subdued policy response. Government support – both monetary and fiscal – officially stands at just over 3% of GDP, with China's augmented fiscal deficit – which includes off-budget fiscal activity often used to finance infrastructure projects – at 17% of GDP[1]. For context, research from the Ninety One Investment Institute shows the US and Eurozone stimulus commitments had exceeded 50% of GDP by the end of March[2]. This adds a sizeable chunk to elevated debt levels in developed nations which will need to be dealt with[3], while China's model of joint fiscal and monetary cooperation – taking measures such as directing banks to lend – is a model that Western governments are increasingly gravitating towards in response to the crisis.

China's industrial production has mostly returned to normal. Strict adherence to the nationwide health code system, sufficient levels of personal protection equipment (largely face masks), widespread testing and the use of technology – such as infrared cameras that measure workers' body temperatures – have collectively helped restore confidence and get people back to work. While supply has been normalising, a decline in demand for exports – linked to more cautious consumers – has impacted some sectors, including vehicles, auto-parts and smartphones, where production is around 80-90% of pre-COVID-19 levels[4]. Real-estate markets have recovered.

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1. Goldman Sachs.
2. Fast & Furious.
3. Dealing with the debt burden.
4. First in and first out.

E-commerce and online businesses have been notable beneficiaries, and the formation of some of the biggest names in the space following the last major health crisis to impact China may offer some lessons for the future. For instance, Taobao, Alibaba's online retailing platform, was launched in May 2003, during the SARS (Severe Acute Respiratory Syndrome) epidemic. JD.com, the largest retailer in China, also came into existence around the same time. Today, Alibaba and JD.com are the two largest index constituents in the MSCI China consumer discretionary sector, highlighting the changing composition of China's equity markets and the fact that consumer behaviour in China has changed dramatically over the last 15 years. In our view, COVID-19 could prove to be a similar watershed moment for a country going through long-term structural change.

COVID-19 may accelerate China's domestic reforms

Previous experience with pandemics has helped East Asia demonstrate better state capacity to deal with COVID-19 compared to developed market peers. However, disrupted supply chains, drops in export demand and the potential that trading partners reconsider their offshore arrangements mean China will need to double down on its domestic focus[5]. Perhaps conscious of this, China's stimulus package to mitigate the impact of COVID-19 appears to have accelerated its transition from industrial to innovation-led services.

The package includes boosting infrastructure investments, such as the 5G base stations, artificial intelligence (AI) and datacentres, intercity high-speed railways, industrial internet of things (IoT), ultra-high voltage grids and electric vehicle charging stations. China's total investment in these sectors is estimated at US$180 billion over the next 10 years[6]. In addition to countering the near-term economic slowdown, these new infrastructure projects are likely to boost long-term productivity by leveraging next-generation technologies. This enables the levers of growth to be driven more by technology than labour, which is positive for sustainable economic growth as it mitigates the demographic headwinds that are on the horizon.

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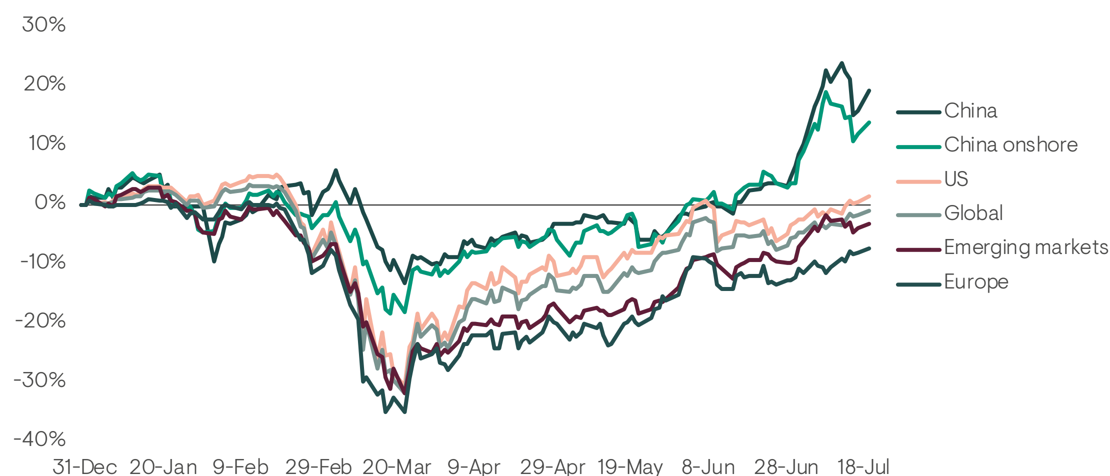
5. Will the pandemic spur deglobalisation.
6. Morgan Stanley.

A major driver of China's growth since 1980 has been the migration of China's rural population to cities where workers increased the economy's overall productivity by moving from farms to factories. The trend is set to continue with a further 10 to 15 million people likely to move to cities each year over the next decade. In addition, reform in rural China – which covers half a billion people – is central to the government's goal of poverty alleviation by boosting incomes, improving food security and achieving environmental sustainability[7]. E-commerce is closely aligned with the government's efforts to rejuvenate the rural regions, which are growing rapidly. We believe China's growth opportunities here should not be underestimated, with Alibaba for instance stating that it sees its rural strategy as one of its three core strategic development plans over the next two decades.

China's markets show encouraging resilience

While the dust appears to have settled somewhat, it is worth remembering that the first quarter of 2020 saw global equity markets suffer their fastest declines in history. However, since the beginning of the year, China's capital markets have been less impacted than both developed and emerging market peers, both in terms of performance and the extent of the drawdowns suffered.

Figure 2: Chinese equity markets have outperformed both developed and emerging counterparts in 2020 YTD



Source: Ninety One, Bloomberg as at 20 July, 2020. See important information for index references.

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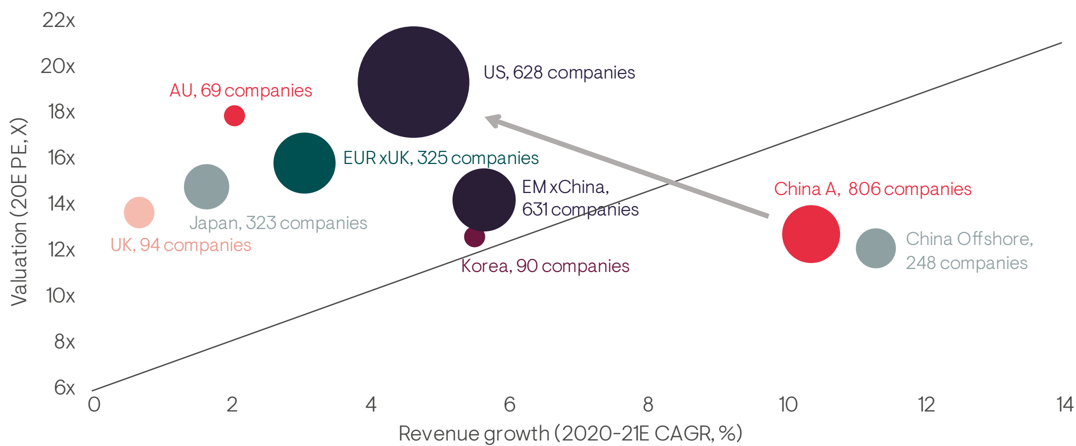
7. Rural China, the next half billion.

A range of factors have contributed to this resilience. Foreign outflows, although large relative to history, are still a small part of what is largely a retail domestic stock market. The raft of measures announced by the Chinese government added important reassurance to domestic investors. Chinese earnings revisions have been more resilient than in other regions and should new COVID-19 outbreaks be contained, we could anticipate some positive earnings revisions in the second half of 2020. Another factor to be cognizant of is that the starting point of the sell-off in China was against much lower valuations compared to the record highs in the US stock market.

As Figure 3 illustrates, the Chinese market is full of rapidly growing companies that were already trading at significantly cheaper multiples than global – particularly US – counterparts, emphasizing the potential for China's markets to re-rate. Not only did this cushion the blow during the sell-off, but once signs of recovery became apparent, investors saw the potential to pick up stocks at even cheaper valuations.

Figure 3: Chinese equities entered the year trading at significantly cheaper multiples than global peers



Bubble size indicates the total listed market caps for the stock universe in different markets. Universe: All active stocks with listed market cap >US$2bn. Note: Aggregate growth and valuations are calculated based on full-listed shares. Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, January 2020.

We believe the trends and reforms that have supported the transformational growth in China are not only set to continue, but in many cases to accelerate.

One of the strongest arguments for Chinese assets remains that they form a large market delivering uncorrelated returns. As Chinese markets open to international investors, that may change. For now, however, we believe holding Chinese assets brings a tangible advantage given the potential to deliver higher risk-adjusted returns. China's equity markets are now the second largest (after the US) and possess distinctive features that represent the China growth story. The country leads in key technologies, including robotics and electric vehicles, and is the only nation outside of the US with several large, mega-cap technology companies. This growth looks set to continue, with China investing more than any other country in artificial intelligence – accounting for some two-thirds of global spend. Given that China's onshore equity market (China A-shares) represents approximately 70% of all Chinese stocks and is dominated by domestic private investors, we believe there are significant alpha opportunities for bottom-up active investors to tap into this growth. The picture further improves when one considers the low correlation between Chinese equities and other major equity markets, enhancing the potential diversification benefits that an allocation can deliver.

Figure 4: China's equity markets show very low correlation to other markets

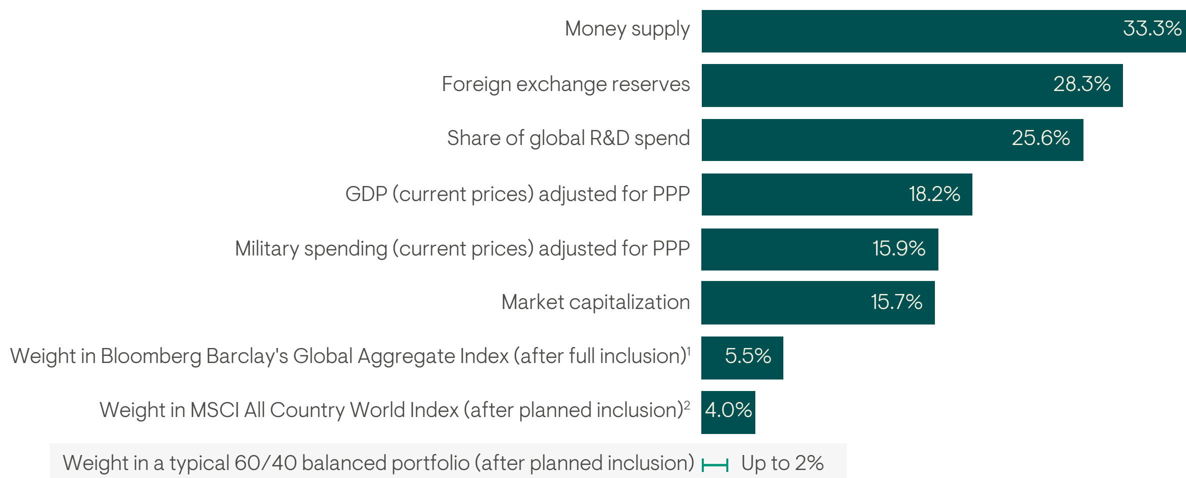
MSCI China	MSCI India	MSCI EM	Shanghai Composite	Shenzhen Composite	MSCI Japan	MSCI ACWI	MSCI Asia Pacific	MSCI Thailand	Indices
1.0	0.6	0.9	0.6	0.4	0.6	0.7	0.8	0.5	MSCI China
	1.0	0.7	0.2	0.1	0.4	0.6	0.7	0.5	MSCI India
		1.0	0.4	0.3	0.6	0.9	0.9	0.6	MSCI EM
			1.0	0.9	0.3	0.3	0.4	0.2	Shanghai Composite
				1.0	0.2	0.2	0.3	0.1	Shenzhen Composite
					1.0	0.6	0.8	0.4	MSCI Japan
						1.0	0.8	0.5	MSCI ACWI
							1.0	0.6	MSCI Asia Pacific
								1.0	MSCI Thailand

Source: Bloomberg as at 31 December 2019

Standalone allocations pass the COVID-19 test

A standalone allocation to China has been and continues to be one of the biggest decisions asset allocators are facing. The COVID-19 crisis has provided valuable insight into China's markets as they continue to offer both diversification and resilience at the time both are needed. For many investors, this has accelerated the decision-making process as allocators consider efficient ways to apply risk in their portfolios. Although China's capital markets are gradually entering popular global indices, most institutions are still underweight China and very underweight China's onshore markets: an active approach is the most pertinent means of achieving an appropriate exposure.

Figure 5: China accounts for significant proportions of global metrics, but this is not reflected in a typical portfolio



Source: Ninety One, BofA Merrill Lynch Global Research, IMF, SIPRI, MSCI, Bloomberg, FactSet, Haver, Wikipedia, OECD Main Science and Technology Indicators, February 2019.

Notes: Market capitalisation for China include A, B and H-shares.
[1]Chinese RMB-dominated bonds are being included in the Bloomberg Global Aggregate Bond index over a 20-month period starting April 2019. The weight denotes the indicative weight of Chinese bonds when fully accounted for in the Global Aggregate index, using data as of January 31, 2018.
[2]Source MSCI as October 2019.

Where does China fit?

Many of the discussions we are having with global allocators continues to be about where China would fit in an allocation framework. Our Multi-Asset team has created a practical model that provides insight into how to build optimal allocations based on minimal assumptions.

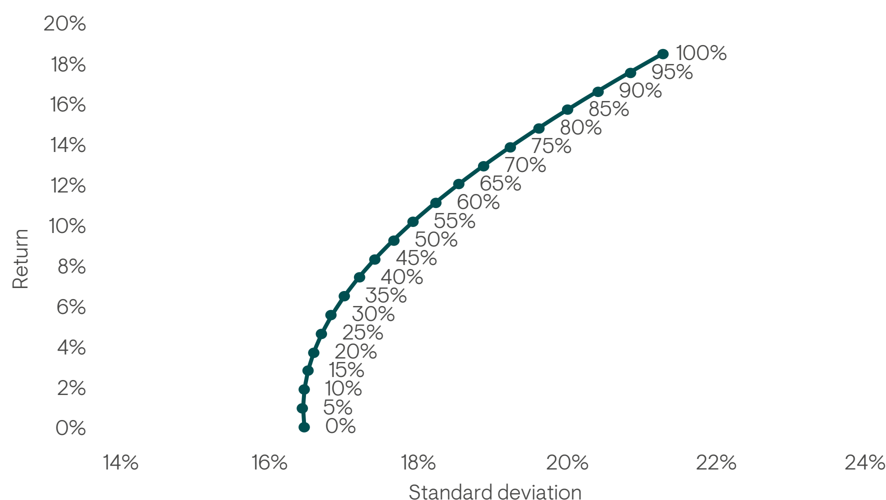
To make a separate allocation to China, an investor must first consider how to size positions, which existing exposures should be removed/or reduced, and the overall impact this would have on potential portfolio risk and return. This can only be fully addressed in reference to the objectives and parameters of a real investment portfolio.

Our asset allocation analysis – which we wrote about extensively in our 2019 paper: 'China: Dig the well before you're thirsty' – models a range of scenarios to help explain where China best fits in an existing portfolio. The base scenario for the allocation model considers Chinese equity markets outperforming developed market equities by 3% per annum and Chinese bond yields as conservatively 1% higher. In such a scenario and with the added diversification benefits, an optimal equity allocation for a traditional 60/40 balanced portfolio would be 16%, and in fixed income, an optimal allocation would be 11%.

How would a separate allocation work within an existing emerging market equities allocation?

One of the most common questions from asset allocators is how a separate China allocation blends with existing emerging market exposure. Figure 6 illustrates the risk-return frontier facing an investor in the MSCI Emerging Markets Index. The chart highlights that an allocation of 15% to Chinese equities would have delivered better returns without increasing the volatility of an emerging market equity (EME) portfolio. In Figure 7, we show how country allocations would likely change with a 15% allocation to Chinese equities with improved onshore China exposure, but without significantly impacting overall EME weightings.

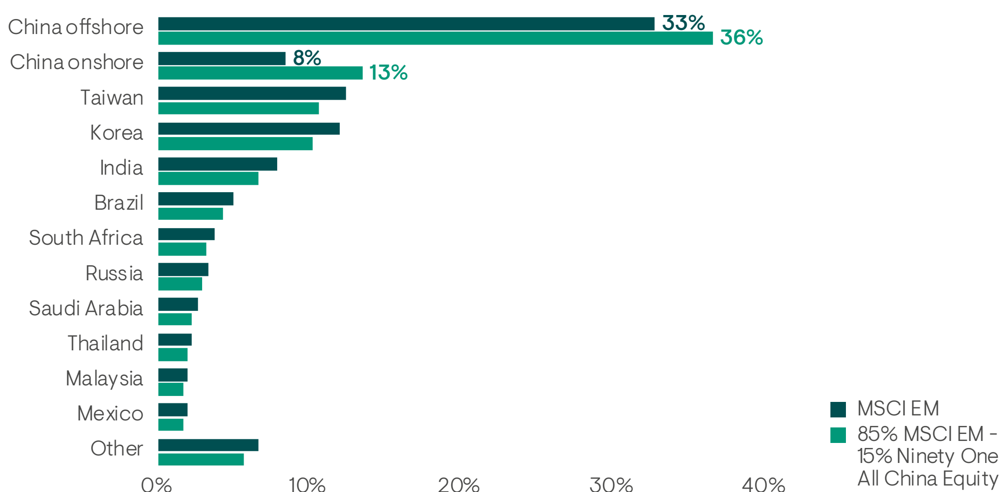
Figure 6: Efficient frontier allocating to Chinese equities



Past performance is not a guide to the future, losses may be made.

Source: Ninety One, Bloomberg as at 30 June 2020. Chart shows the efficient frontier between MSCI Emerging Market Equities and Ninety One All China Equity Strategy gross of fees. See important information for further information on the impact of fees.

Figure 7: Overlap with existing EME allocations



Source: Ninety One as at 30 June 2020.

Conclusion

After the world has traveled through this COVID-19 pandemic, asset allocation will become even more important for investors looking for diversification potential. Headwinds clearly remain in China; we can expect the political tensions between the US and Beijing to ramp up ahead of the US presidential elections in November. For instance, the potential legislation that recently passed the US senate would require overseas companies listed on American stock exchanges to follow US standards to audits and other regulations – including the need to certify that a company is not under the control of a foreign government. Clearly targeted at China, it is unlikely the larger Chinese companies would comply with this and some – as we have already seen – may seek to gain international exposure by listing in Hong Kong instead.

Another headwind that may flare up again in a post-COVID world is the strained relationship between Hong Kong and China. While obviously challenging, long-term investors such as ourselves on-the-ground in Hong Kong, seek to look through the changing landscape and assess the dynamics from all angles. Long-term, the considerable growth potential that exists across China and the region is a secular trend set to continue. We believe that this growth engine will rebound strongly – with staggering levels of domestic investment planned over the next decade – and continue to deliver attractive returns that warrant a standalone allocation to China.

General risks: The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results.

Specific risks: Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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Impact of fees

Figure 6 shows the efficient frontier for an allocation to the Ninety One All China Equity strategy. Performance is gross of fees (returns will be reduced by management fees and other expenses incurred), income is reinvested, in USD. Example effect of compounded management fees over 10yrs on the value of a client's portfolio: Initial value = US$100m, assumed return = 10% p.a., grows to US$259m (no fees), grows to US$241m (0.75% p.a. net fees). The annualised returns over 10yrs are 10% (gross of fees) and 9.18% (net of fees). The fees are calculated on a monthly basis, showing the maximum effect of compounding.

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