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What's your next move in China investing?

UBS Asset Management

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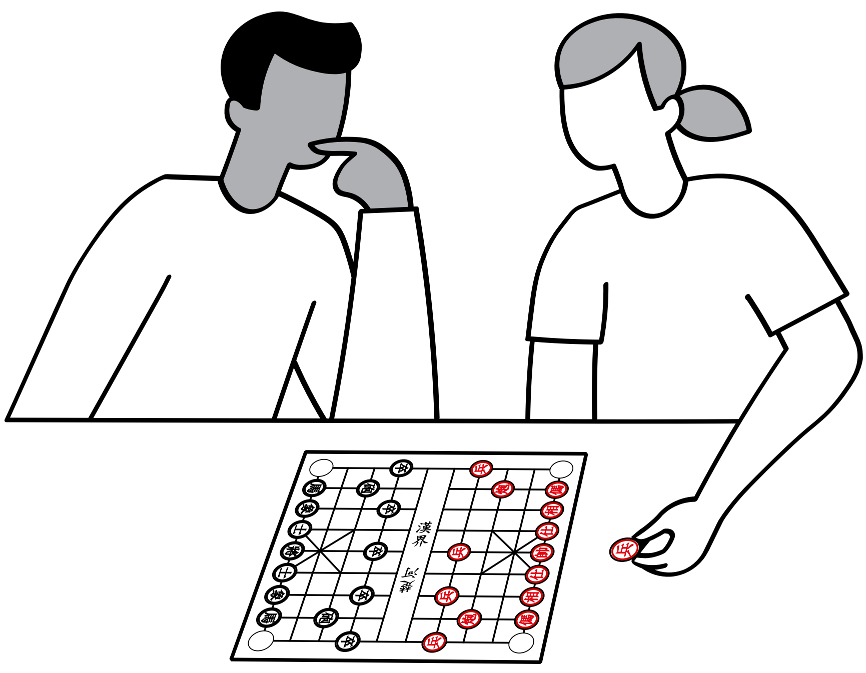
Investing in China lately has come with higher risks and volatility, but the scale and variety of opportunities on offer remain compelling to those looking for returns across asset classes for the long run.

Have you played Xiangqi before? Xiangqi, also called Chinese chess or Elephant chess, is a popular strategy game played by Chinese people from all walks of life. With two armies battling it out on the chess board, it has a lot in common with International Chess, Indian Chess, Shogi (Japanese) and Janggi (Korean).

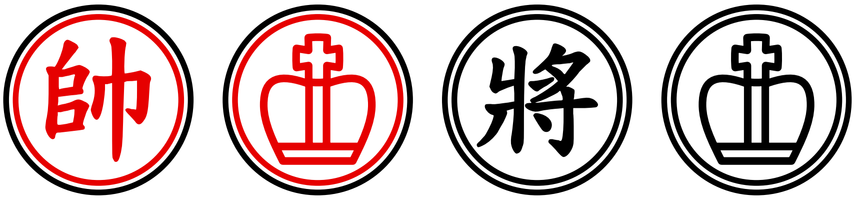
A player's quick tactics in opening the game and advancing pieces across the river – together with a well thought out strategy – are key elements to the ultimate victory of capturing the enemy's general. But finding the right moves is not easy.

The same can be said about investing in China, with COVID resurgences in major Chinese cities, lingering regulatory risks, property market distress, the start of an aggressive US monetary tightening cycle, and most devastatingly, the war in Ukraine. Have these recent events changed the momentum on the China growth board? Has your China investment approach changed?



War in Ukraine

The General cannot move outside the Palace



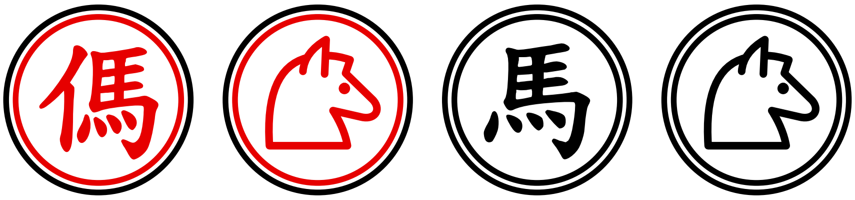
Market volatility in China had already been at an elevated level in recent months on slowing (but still above developed market) domestic growth, coupled with decelerating global growth and lingering fears of further regulatory clampdown before Russia's invasion of Ukraine, which sent nervous investors into a frenzy and caused some to actively look for the exit. It is impossible to predict how the war will develop, but we unfortunately expect a prolonged period of fighting in Ukraine, with a quick resolution to the war and the sanctions on Russia unlikely.

Speculations and at times aggressive rhetoric on where China stands and its role in the conflict brought on more unease regarding Chinese assets, since any political action to support Russia could bring international sanctions. Speculations so far have remained speculations, and even as China refuses to condemn the Russian attack, it has made no move beyond the line in the sand. However, the close economic links with Russia continue. The ongoing war has disrupted the world's supply chain as trade routes on land, air and sea experience interruptions. China is not immune to higher commodity and energy prices – or a global economic slowdown or possible deglobalization triggered by the war. Partly because its economy relies more on domestic growth and partly because it is not participating in western sanctions against Russia, in the long term we think China could be insulated from some possible spillovers compared to the most western countries.

Russia continues to trade with China in oil and gas. There are also talks of a new energy agreement between China and Russia that could include new oil pipeline projects and Chinese investment in Russian energy companies after sanctions drove the exit of western ones. Whether China's economic cooperation with Russia would provoke an international response remains to be seen, but ultimately the war is driven by geopolitical power struggles and we don't believe it's in China's interest to get involved or take any action that would result in a wide-reaching backlash at this time.

COVID outbreak and lockdown, dynamic zero policy

The Linked Horses formation grants safe but imperfect protection



The war is not the only deterrent to growth. Omicron outbreaks in China and the resulting citywide lockdowns in major hubs such as Shanghai are also raising growth concerns, as well as questions on whether the dynamic zero tolerance COVID policy is sustainable or the right approach for China. After the initial outbreak more than two years ago, the country has had remarkable success containing the pandemic up to the current flareups, with significantly fewer deaths than some of the other major economies, but it is now almost alone in putting the welfare of the most vulnerable in society ahead of economic recovery and market sentiment. Part of the hesitation in scaling back the restrictions and “living with the virus” we believe is the inevitable increase in deaths. China has so far been relying on domestically developed inactivated vaccines and is accelerating the development of its own mRNA vaccine. Meanwhile, it will continue to adhere to painstaking measures like travel restrictions, mass testing and large-scale quarantines to contain the spread of the virus.

It would be a mistake, however, to think that China is doing nothing about the economic toll. With stoppages in logistics, road transportation and manufacturing production in port and industrial cities, the government has reshuffled more of the container traffic from roadway to waterway, trying to ease some of the pressure from the disruptions in the flow of industrial goods. Some lockdown measures have recently been relaxed – there are different levels of restrictions and some neighborhoods are allowed a limited amount of movement and activities – and production has in fact restarted for many companies. China has promised to do more, hoping stronger monetary, fiscal and credit support would provide relief and buffer the overall growth shock that we believe should have a short- to medium-term in impact.

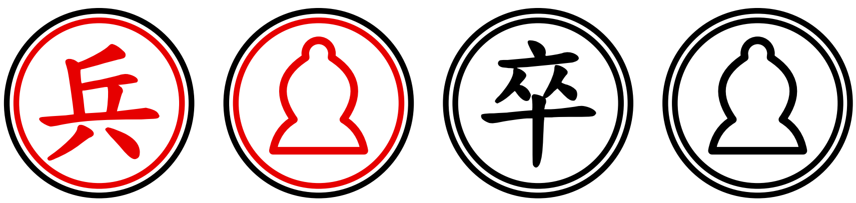
Although we think there is still room for Chinese interest rates and monetary policy to be more accommodative, efforts such as investment proposals in infrastructure, renewable energy and property support could help China get through this rough period. These stimulus efforts should carry a bigger weight toward the second half of the year, when COVID is – hopefully – under better control, and help the economy get back on track in the long run. It's also important to remember that China’s pace of growth, though slowing, is still markedly faster than the rest of the world.

Property market distress, regulatory clampdown

Cannot fire the Cannon without a mount

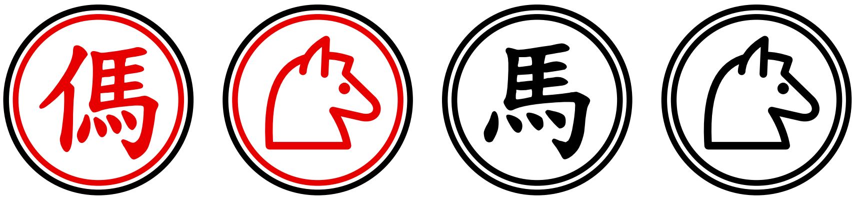
COVID resurgences have not only disrupted the global supply chain, they are also keeping the beleaguered housing sector down. And China's fixed income strategies are impacted by it. After last year's regulatory clampdown on overleveraged housing developers sparked fears of contagion risk in the financial system, the government has since stepped back and turned more supportive, loosening credit controls and reducing home purchase down payment requirements in certain cities. But home sales, prices and construction have yet to regain a footing and recover from last year's rapid declines before the Omicron wave and mobility controls hit. We expect volatility to continue in this sector at least over the rest of the year before a clearer policy is articulated and implemented.

That said, new guidelines to ease the rules governing escrow accounts (trusts holding pre-completion cash) appear promising, and if implemented, they could provide much needed liquidity to property developers after last year's cash crunch and indiscriminate write-offs. State-owned enterprises (SOEs) are playing a greater role, moving in to carry out merger and acquisition (M&A) activities by acquiring projects or other assets from distressed developers. We are optimistic that conditions will improve after the Omicron flareups ease, particularly for the better-capitalized companies with solid balance sheets and more readily-accessible funding channels. In the long term, we expect that these property developers will survive the current industry consolidation and emerge in an even stronger position.



Opportunities in step with China’s objectives and priorities

Endgame compositions



The culmination of these recent events – some expected, some unexpected – in the past few months unnerved investors, but there has always been a lot of volatility when it comes to investing in China. It’s helpful to take a step back and look at the big picture. Over the past decade China has been in a boom, punctuated many times by the expectation of a hard landing or meltdown. Each time, China has made its way out. Today, the macroeconomic picture in China is driven by the overarching objectives that the Chinese government is looking to achieve. These include: improving security, financial market stability, common prosperity, the environment, dual circulation and demographics. Most of these long-run goals are a net positive for the long-term development of the Chinese economy – and therefore for investing in China – despite generating short-run headwinds for some sectors and companies, as evidenced by the regulatory intensity last year.

Beijing’s long-term goals illustrate how the Chinese model of growth is evolving from a focus on the quantity to the quality of growth, transitioning to a more domestic, service-oriented economy, shifting priorities to balancing growth and sustainability, tackling social equality and security, after a decade-long journey to eliminate absolute poverty. We believe the increased focus on automation and digitization, healthcare, life insurance and asset management, deleveraging and stronger balance sheets, and the move towards green energy and a cleaner environment, are among the long-term trends that make China’s investment case attractive.

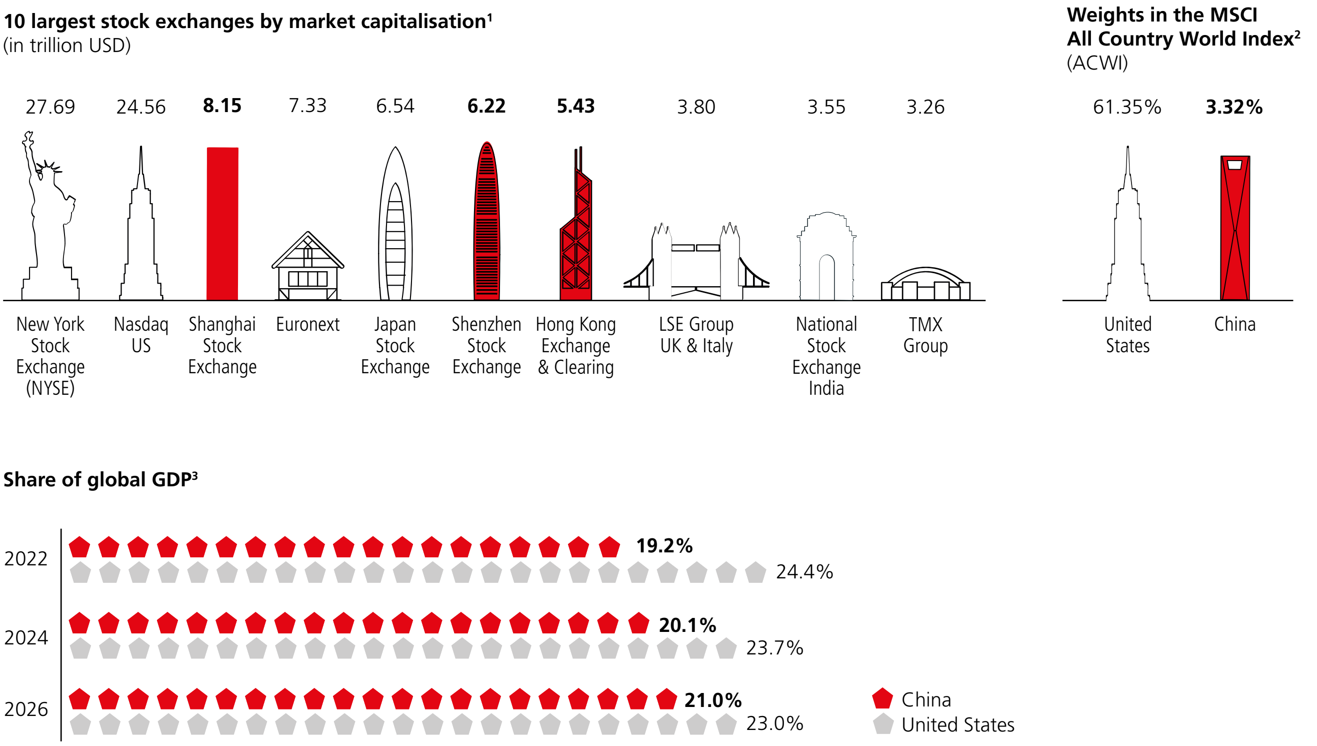
Why invest in China

Don’t be forced into Zugzwang

We are behind the long-term China investment case, while acknowledging higher risks and more near-term volatility, and cognizant that not everyone feels the same way. Simply put, we view China as a core standalone allocation, the same way that we look at the US, Japan, Europe and the UK. China is the second largest economy in the world and one of the most significant drivers of global growth, but investors are still underinvested (Chart 1).

Chart 1: The world is underinvested in China

China is the second-largest stock market but significantly under-represented in global portfolios



1 Source: Trade Brains, 10 largest Stock Exchanges in the World 2021, data as of February 2022.
2 Not to scale, for illustrative purposes only. Source: MSCI data as of March 2022.
3 Source: International Monetary Fund, World Economic Outlook Database, Gross Domestic Product (GDP), current prices in USD, estimates, April 2022.

The country's pattern of growth differs from other markets, both in emerging and developed regions, and its monetary policy direction is also diverging from the rest of the world. Although this can sometimes create short-term headwinds, it also means that Chinese equities and fixed income asset classes offer investors low correlation and diversification benefits (Chart 2) compared to other widely-held portfolio allocations. The scale and variety of the opportunities offered is compelling to investors looking for both market and active returns across asset types. These factors mean that China offers active opportunities for investors, both from an overall portfolio allocation perspective and within individual asset classes. China's capital markets also continue their rapid internationalization through index inclusions and the lifting of capital market controls.

Chart 2: China A benefits from low correlation across global indices

A strong case for inclusion in a portfolio for diversification purposes and improve risk-return profile

Correlation (TR USD)

January 2002 to April 2022

	MSCI North America	MSCI Europe	MSCI Pacific	**MSCI China ex A-Shares**	**MSCI China A-Shares**	MSCI EM Asia ex China	MSCI EM EMEA	MSCI EM LATAM
MSCI North America	1.00	0.88	0.76	0.58	0.36	0.76	0.73	0.69
MSCI Europe	0.88	1.00	0.80	0.64	0.37	0.79	0.82	0.75
MSCI Pacific	0.76	0.80	1.00	0.66	0.36	0.76	0.79	0.68
MSCI China ex A-Shares	**0.58**	**0.64**	**0.66**	**1.00**	**0.60**	**0.74**	**0.68**	**0.61**
MSCI China A-Shares	**0.36**	**0.37**	**0.36**	**0.60**	**1.00**	**0.42**	**0.34**	**0.35**
MSCI EM Asia ex China	0.76	0.79	0.76	0.74	0.42	1.00	0.81	0.76
MSCI EM EMEA	0.73	0.82	0.79	0.68	0.34	0.81	1.00	0.83
MSCI EM LATAM	0.69	0.75	0.68	0.61	0.35	0.76	0.83	1.00

Source: Bloomberg, as of 30 April 2022

Please note that past performance is not a guide to the future.

Equity

Must move the Chariot in the first three moves to win

Understanding Beijing's overarching objectives and their potential implications should be front and center for any successful China investment strategy, and is an increasingly important consideration when picking stocks. China equities are volatile partly because the market is retail investor-driven, which is challenging but also presents a clear opportunity for active managers with the on-the-ground knowledge and research capabilities to identify and take advantage of mispricing and deliver value for investors. We have always believed that it's about picking the right stocks in a fast-changing environment—and we are now in an even faster-changing environment than ever before.

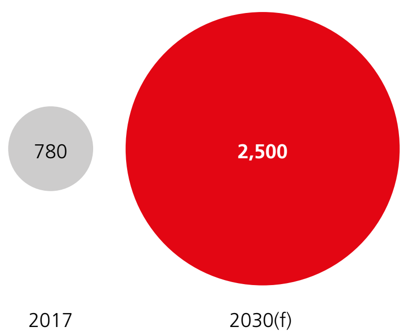
Some of the most exciting long-term equity opportunities have been in the healthcare sector as we believe Chinese healthcare expenditure will continue to grow at double digits (Chart 3). We are positive in the long run on select leading pharmaceutical companies with rich innovative pipelines to diversify from the impact of reduction in drug prices, as well as Contract and Research Organizations (CROs) which are gaining international recognition in new, advanced drug therapies such as cell and gene therapy.

In the financials sector, there is great potential in the insurance segment and wealth management services as the country continues its decades-long transition from low income to affluence. We believe the need for these financial products and services is somewhat

Chart 3: An aging population presents opportunities

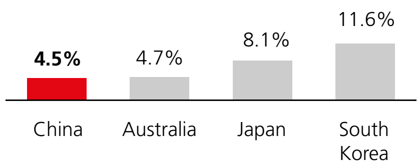
When challenges become investment opportunities: healthcare and insurance services will raise demand for asset management services too

Healthcare market size in China
(USD billions)



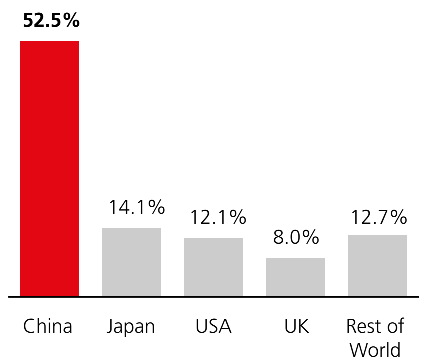
Source: China Daily, December 2017

Insurance penetration
Gross written premiums as % of GDP, 2020

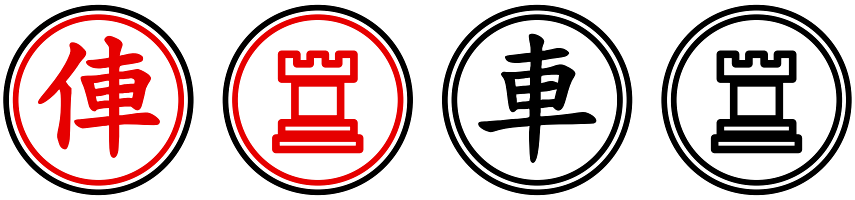


Source: Goldman Sachs Research, February 2022

Asset management services
5 years average growth in AUM[1] ending March 2022 (%)



Source: Morgan Stanley Research, EPFR, May 2022
[1]AUM = Asset under Management



nascent and can become significant with time, given the progression is structural in nature. While part of China is still in lockdown, we believe that when it does eventually open up, investing in the banking sector will be an attractive way to participate in the reopening.

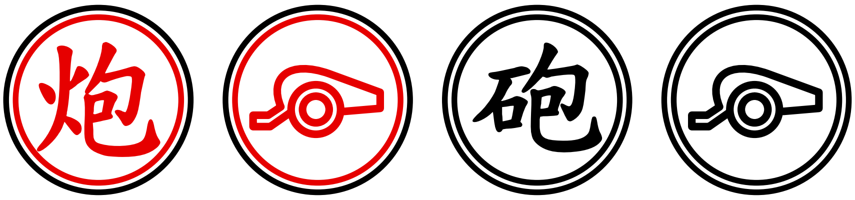
But "opportunity" also sometimes means being patient and waiting on the sidelines when necessary. Given our focus on the fundamental story and the fundamental value of the companies we own, last year we did not get carried away by the hype in certain sectors such as the renewable energy space, particularly the electronic vehicle (EV) industry. As we saw it, there was a big gap between the valuations these EV companies were trading at and their fundamental value, even after accounting for government support. Not investing in this part of the market has shielded us from much of the volatility of the past few months. We continue to believe that our holdings of good quality companies with strong competitive advantages will deliver results in the long run as investor focus returns to sector and company fundamentals.

Fixed income

Defend the center with the Central Cannon opener

The long-term investment case for onshore China fixed income is likewise intact. Given the still relatively low global yield environment and the low correlation between China and global rates, we expect China fixed income to remain attractive vis-a-vis other global bond markets both on a yield basis and also from a diversification point of view.

In the short term, we expect the China fixed income market to still trade based on domestic economic fundamentals that are under huge downward pressure. Exports are expected to remain relatively strong despite COVID lockdowns in several cities, which will add to GDP growth in 2022, but with the ongoing Ukraine war, European and US demand could slow and add to the pressure from the global economic slowdown. Both factors could trigger more aggressive monetary and fiscal stimulus in China. We think there is still room for China rates and monetary policy to be accommodative, as stated in a government work report by Premier Li Keqiang on behalf of the State Council. This will continue to support China fixed income.



With the US Federal Reserve back on a rate hiking path and monetary policy diverging between China and the US, the difference in interest rates is narrowing as US rates rise. Market concerns about the China-US yield advantage has led to some short-term volatility in China rates, but we think the concerns may be exaggerated. This is not the first time that we see diverging economic and monetary policies in the US and in China. For example, in 2018 when US yields were on an upward trend, China faced an economic downturn and the People's Bank of China implemented four rounds of reserve requirement ratio (RRR) cuts despite continuous rate hikes stateside. Looking back, the outflows from China bonds by foreign institutions and the resulting depreciation pressure on the Chinese yuan (CNY) in 2018 was larger compared to what we see currently. Overall, we believe the weakness in economic fundamentals in China, the monetary policy easing and the backdrop of the relatively stable CNY currency will be supportive for CNY bond investors.

When the economy turns around, possibly in the second half of the year, there may be opportunities in the China US dollar-denominated credit markets. Investment grade and high yield spreads in the US and Europe are still very tight compared to China high yield bonds, and this could be the time to consider Chinese high yield securities, in particular property. It's true that the property market is not out of the woods yet, but with the current market pricing in what we believe to be an unrealistically high 55% default rate, we think valuations are attractive and there are quality companies to choose from for the long-term investor. For investors who are already invested in Asia high yield, a shift into China high yield could be beneficial as a means to express a more pointed exposure.

Over the longer term, we still expect the favorable valuation and risk characteristics of China fixed income to continue to attract global investors. The continued increase of China's weight in global bond indices will serve as a tailwind for the sector over the medium term. Further liberalization of Chinese financial markets should attract new investors as well. In the end, we believe China's yield story is still an attractive one even though policy is changing and global uncertainties are high. Today's Chinese sovereign bonds offer a 1-2.5% yield pickup over some major developed market bond markets (UK, Switzerland, Germany, Japan), delivering real yields through low correlations. China high yield credit spreads are at their all-time widest, and the China bond market still presents many investment opportunities.

Alternatives

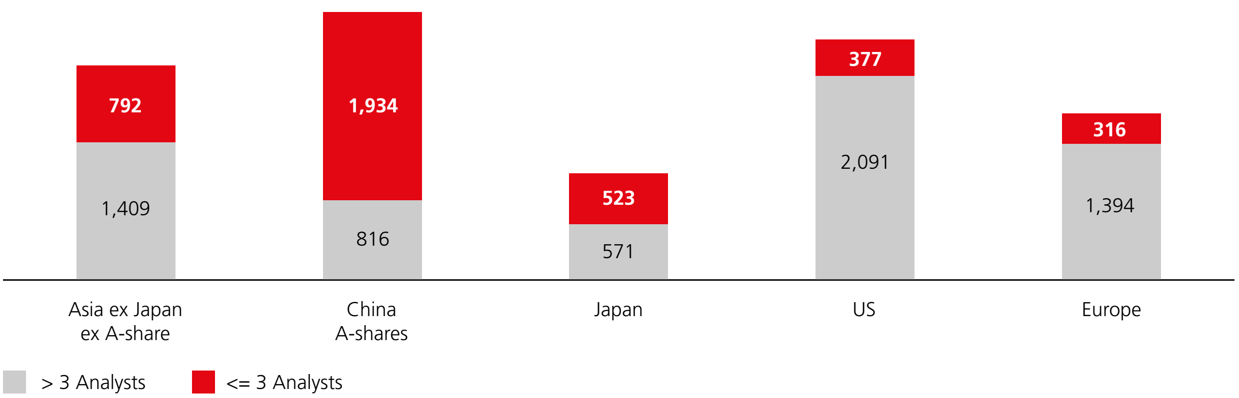
Surprise checkmate by stacked cannons

While Chinese stocks and bonds continue to present compelling investment opportunities, China is no longer just all about traditional asset classes, or even onshore versus offshore investments. In its pursuit to become one of the main global financial hubs, over the last few years China has actively focused on reforming its financial sector, and we believe that this is creating opportunities for relative value trading that weren't available to investors in the past. China's markets are becoming a key source of alpha and its transition from beta to alpha is one of the key trends in relative value investing at least over the next 5-10 years. There are at least three market characteristics and developments that are supportive of a more relative value approach to investing in China.

First, high retail participation and relative underinvestment by international and institutional investors – especially in A-shares – provide interesting entry and exit points as well as the ability to trade around that high market turnover for relative value investors. The dominance of retail investors creates dramatic swings in momentum and valuation skews, which can present unique alpha opportunities for relative value investors on both the long and short side of portfolios. The A-share market has had very low correlation to the offshore market, as it is driven by its own dynamics and is also extremely liquid, allowing institutional investors to trade sizable amounts with ease. While the influence of institutional investment capital is growing, we think it will take years for it to overtake retail investors as a key market driver. As we see it, this imbalance creates a compelling window of opportunity that active investors can seek to exploit.

Second, low coverage by sell-side analysts means that not much information is widely available, which is conducive for alpha generation from both the long and short side (Chart 5). Most of the A-share companies are minimally covered by analysts compared to the much higher level of coverage of other major markets. Additionally, only a small portion of A-share companies have English language research coverage – which means that the visible opportunity set for global investors remains small.

Chart 5: Listed company equity analyst coverage: China's equity universe is under-researched



Source: Reuters Eikon; UBS HFS, as of April 2021. Universe is based on companies with >=$500m market cap and >=$0.5m average daily turnover. Universe is based on stocks listed in Japan, China, United States, countries within MSCI AC Asia, countries within MSCI AC Europe.

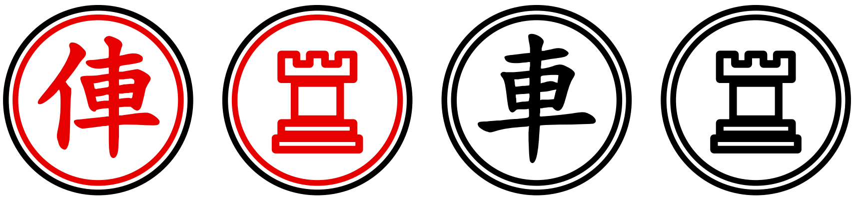
And last but not least, the use of short selling as a risk management tool to protect long positions has historically been limited by the availability of short borrowers in China. However, last year's implementation of the new rules to improve liquidity through opening the Chinese capital market allows active long/short investors to reach out to domestic investors such as domestic mutual funds, life insurance companies and corporate investors. This has doubled the size of the borrowing pool and could mean a five times growth for the relative value market when it matures in the long term according to our estimates. These regulatory reforms will fundamentally change the operating characteristics of the China A-share market by allowing hedge fund investors to short with domestic brokers and secure margin on a range of securities that were not available in the past. Hedge funds will therefore be able to more effectively capture long and short alpha while dynamically managing beta, sector, factor, thematic and idiosyncratic risks.

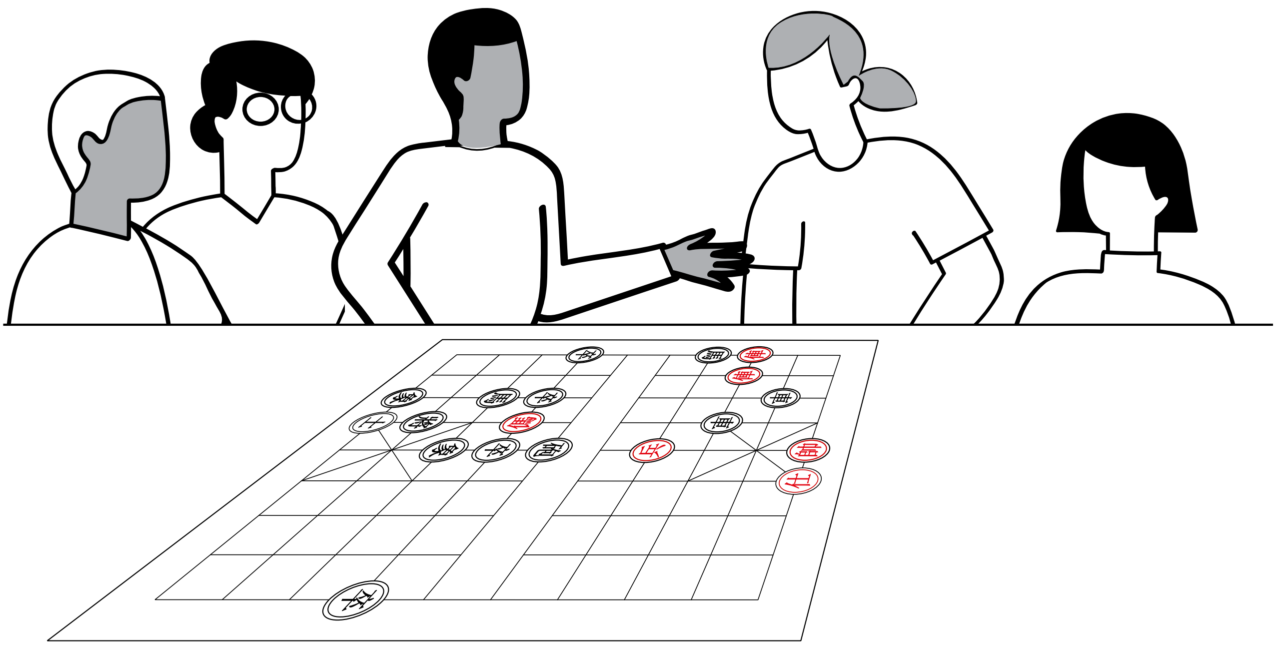
We believe there is a large investment opportunity in China as liquidity improves on both the long and short side. We are also looking at quantitative strategies in China and are closely studying their credit and fixed income markets. These strategies may bring about much more efficiency and allow us to invest in a much more diverse way across the onshore Chinese equity markets. Investors who are bullish on China yet weary of short-term volatility should consider adding long/short strategies to their allocation.

Conclusion

The Chariot can go far and wide

China is a country of many strengths and potential, and offers plenty of attractive long-term opportunities. While it's clear that risks to investing in China have risen and recent events have many investors on edge, we firmly believe the long-term investment case for China is intact.





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