One-on-one interview

Chinese equities in the Year of the Ox

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Key takeaways:

- With China bouncing back from the pandemic, corporate earnings growth looks poised to expand from a low base, supported by an inventory restocking cycle and robust exports
- The latest Five-Year Plan will open up opportunities around three major themes – digitalisation, technology localisation and domestic demand – and refine the investable universe over the next five years, in our view
- In China's A-share market, the so-called "new economy" companies in healthcare, consumer products and technology continue to provide high quality and promising growth opportunities to investors

What is the market outlook for Chinese equities in the Year of the Ox?

In 2021, we expect the macro recovery in mainland China to continue to lead global markets with a general rollout of effective vaccines. At the company level, corporate earnings will be supported by an inventory restocking cycle and robust exports, which are historically positively correlated with total industrial profit growth. The consensus earnings estimates of onshore and offshore Chinese listed companies turned positive in August last year and has stayed positive since then, implying potentially more upward revisions from current levels. According to market consensus in January, the earnings per share (EPS) growth for MSCI China is expected to rise 25% in 2021 and 15% in 2022, respectively, comparable to the US's 21% and 15% over the same period.

In addition, we expect RMB appreciation to continue in 2021, supported by solid exports, capital inflows and different policy cycles between mainland China and the US. A strong RMB typically helps draw capital inflows into Chinese equity markets and in particular Hong Kong SAR-listed Chinese companies which report their earnings in RMB. In our view, the key theme to watch out for is the government policy in 2021. We are seeing the normalisation in fiscal, monetary and credit policies, but there is no expectation for abrupt tightening. Policy tightening in the property market is likely to continue, and there is no sign of loosening in the near terms. In this benign environment, we think the key risk is whether the pace of tightening is likely to be pre-mature or too strong. But for now we don't see the policymakers tightening too aggressively given the uncertainty around the path of the global recovery. Overall, we remain optimistic about Chinese equities this year.

Fig 1: Industrial profits have grown robustly

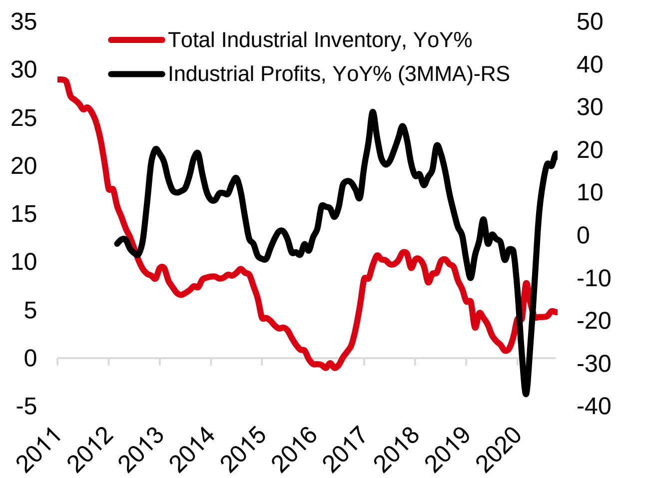
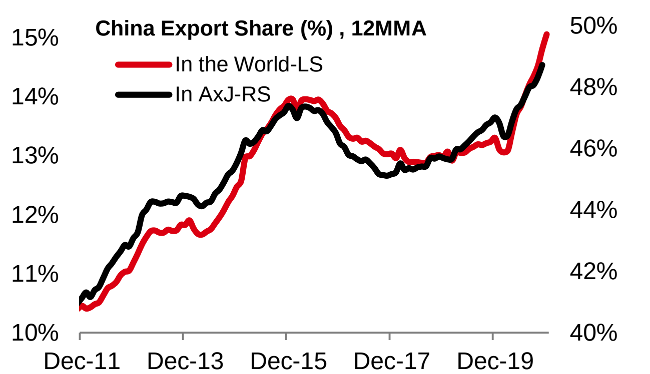


Fig 2: China's solid exports recovery



Source: CEIC, Morgan Stanley, HSBC Global Asset Management, January 2021

2021 will be the first year of the 14th Five-Year Plan (2021-2025). What investment opportunities do you see arising from the new plan?

In the latest Five-Year Plan, we expect to see a significant increase in research and development (R&D) spending for technology innovation and advanced manufacturing. From a strategic standpoint, the economic blueprint will open up opportunities around three major themes – digitalisation, technology localisation and domestic demand – and refine the investable universe over the next five years.

In our view, the rise of the digital economy is more than just shifting offline business to online. It includes a new breed of companies such as autonomous driving, internet of things (IoT), virtual reality, education technology and robotics and drones, all of which have significant room to grow and fundamentally changed the way we live today.

As for technology localisation, Chinese policymakers have strong motivation to reduce their reliance on imports for production and national security reasons, given uncertainty around the broad-based US technology ban. This reliance is exemplified by the semiconductor industry where the core technology and materials are mostly controlled by developed countries. (China has a plan for 70% self-sufficiency by 2025).

Lastly, the domestic demand theme can be subdivided into consumption and investment, such as promoting income growth through fiscal support and social reform and investing in digital infrastructure.

Additionally, China's commitments to hit peak carbon emissions before 2030 and for carbon neutrality by 2060 will provide plenty of investment opportunities with policy support along the green agenda.

What are the key investment themes in a post-Covid environment?

A general rollout of the Covid vaccines, a V-shaped economic recovery (2021 GDP growth is projected to expand 8.2% from 2.3% in 2020) and more predictable US-China relations in the first year of the Five-Year Plan provide a favourable backdrop for the rest of 2021, but there is still a great amount of uncertainty around the pandemic situation, the tensions between US and China and the path to global economic recovery.

In the shorter term, we like the recovery play. Companies in travel, hotel and airlines are likely to see a significant pick up towards the end of 2021, after seeing some very sharp declines during the pandemic period. We believe consumer-facing sectors should disproportionately benefit from the rollout of vaccines given their high intensity of human interactions and relatively slow recovery so far in the normalisation period.

Over the medium-term, investing along with the policy objectives has been strategically rewarding in China. The Five-Year Plan, for instance, provides a set of key objectives and strategic goals, which touch upon many specific sectors and investment themes for active managers.

In addition to this, we expect Chinese equities to have a bigger representation in global indices such as MSCI and FTSE over the next five years, as the asset class has gained a larger share of global market cap in recent years. The market cap of China A-Shares surpassed USD10 trillion for the first time in 2020, making it the world's second-largest market after the US.

Finally, we think active mandates globally are likely to take a stronger position in Chinese stocks going forward, amid a very active IPO market and ongoing progress in financial market reform.

Fig 3: Market cap of China A-shares hit the USD10 trillion mark amidst the global IPO frenzy

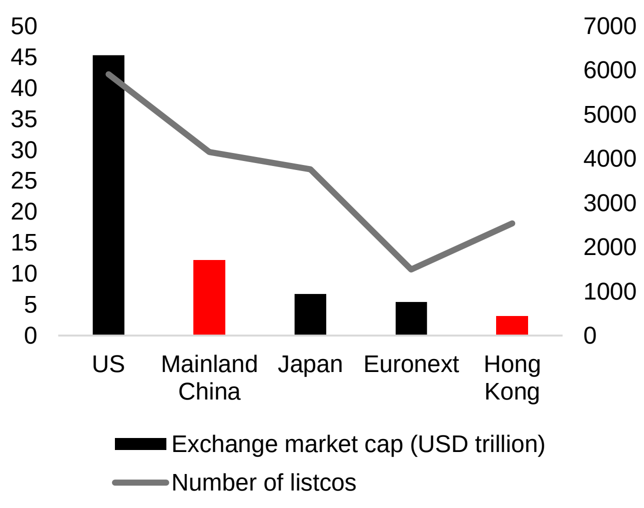
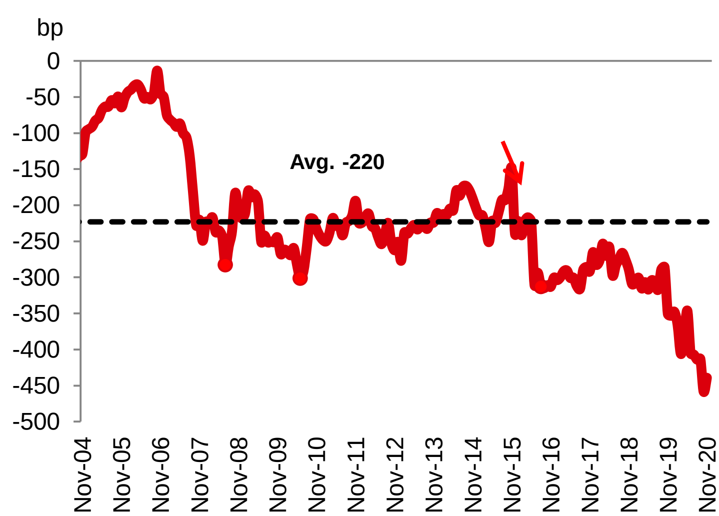


Fig 4: Global active mandates have had the lightest allocation to China A and H shares over the past two years



Source: CICC, Goldman Sachs, Bloomberg, HSBC Global Asset Management, January 2021

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What market opportunities do you see in China A-Shares market?

China's onshore equities constitute the world's second-largest stock market after the US, with over 4,000 listed companies, many of which offer unique investment opportunities that can't be accessed elsewhere. The Shanghai and Shenzhen-listed A-shares market is home to 50%-80% of companies in sectors that make up China's "new economy", namely healthcare, consumer products and technology. Many of them provide high quality and promising growth. Thus, China A-Shares now account for a more significant portion of our Chinese equity portfolios.

In particular, we like domestic companies focused on technology advancement that are gaining global market share or taking on a more important role in global production chain. These players could potentially catch up with global competitors in terms of research and development and capacity expansion over the next three years, with more patents registered in global markets. Therefore, they would be able to maintain their leading position in terms of precision manufacturing, efficiency and cost with more pricing power and better ability for margin expansion. These opportunities can be found across various industries, such as medical devices, consumer electronics, electric vehicle batteries manufacturers.

We think consumer staples companies with strong brand names and dominant market positions will benefit from increasing margins driven by more distribution channels, higher customer loyalty and product premiumisation. The market will also reward their increasingly prominent scarcity value with higher multiples.

Why should global investors include Chinese equities in their long-term portfolios?

China is the only economy in the world to show positive economic growth in 2020. China is also expected to be the largest global growth engine over the next 5 years. According to International Monetary Fund (IMF) data, China's contribution to global growth is expected to increase from 26.8% in 2021 to 27.7% in 2025, which is more than 15% and 17%, respectively, higher than the US' share of expected global output. China's economic growth is also becoming more broad-based and diverse, with domestic consumption and private-sector companies accounting for larger shares.

Even after major index providers started including China A-shares in their global indices, Chinese equities still account for a relatively small portion of key global indices (e.g. 5% of MSCI EM Index), when compared with it's share of global equity market capitalisation (~17%). Chinese equities and China A shares in particular, remain underinvested and underrepresented in global portfolios indicating a lot more potential for inflows into the market in 2021 and beyond.

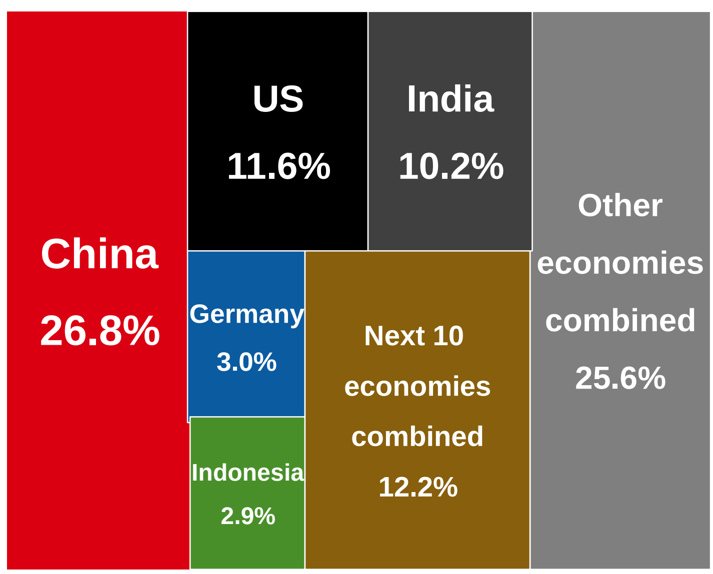
Chinese equity markets, especially China A-shares, have a relatively low correlation with its developed and emerging market peers, as the domestically-traded market has been largely closed to foreign investors in the past. Despite the large strides made in opening up the A-share market in recent years, foreign investors own only about 9% of the onshore market at present, compared with 30% for Japan and 15% for the US. We believe that adding Chinese equities into global equity portfolio could serve to improve its diversification and increase its returns over the long term.

Fig 5: China A-Shares has a relatively low correlation

	MSCI China	**MSCI China A**	S&P 500	MSCI Europe	MSCI AC World
MSCI China	1.00				
MSCI China A	0.80	1.00			
S&P 500	0.64	0.47	1.00		
MSCI Europe	0.62	0.47	0.81	1.00	
MSCI AC World	0.70	0.53	0.97	0.91	1.00

Source: Bloomberg, weekly USD return correlation in the past three years, 31 January 2021

Fig 6: As a share of global economic growth in 2021



Source: IMF. Individual economy's forecast growth, as a share of increase of world GDP, between 2020-2021. Purchasing power parity based.

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