Taking stock of China’s equity markets

September 2017

The information contained in this publication is not intended as investment advice or recommendation. Non contractual document.
China’s transformation: 8 striking facts

At USD 5.8 trillion, the service industry accounted for over half of China’s GDP in 2016. Rapid growth in the tertiary sector suggests that China’s “world’s factory” label is past its expiry date.

In 2016, imports from China accounted for 14% of total global imports. Meanwhile, exports as a percentage of China’s GDP fell to 10%.

In 2016, total mobile payment transactions (USD 5.5 trillion) in China was 50 times that in the United States. The remarkable growth in digital technology has fuelled the development of integrated online ecosystems, the likes of which are yet to be replicated elsewhere in the world.

The number of internet users has grown 1,200 times over the past 20 years. However, this represents only 53% of the population, highlighting significant growth potential.

In 2016, 28 million cars were sold in the past 12 months, a number that almost matches the combined population of Australia and New Zealand.

800 million people now reside in urban areas, representing more than half the total population.

29% (USD 630 billion) of exports from China in the past 12 months came from high-tech products, such as mobile phones and computers. The “Made in China” tag has increasingly found its way into innovative products.

7,600km² of new floor space is currently under construction in China, equivalent to 6.1 million Olympic-sized swimming pools, which can cover the circumference of earth nearly eight times.

Source: NBS, CNNIC, iResearch, World Bank, Bloomberg, HSBC Global Asset Management, data as of July 2017
**Why invest in the Chinese equity market?**

**Higher quality, normalised growth**

- **Economic growth has stabilised and activity has picked up:** China’s growth momentum has been sustained, with support from broad-based positive factors including a sharp recovery in exports, improved corporate profits, higher commodity prices, upswings in manufacturing and private investment, strong momentum in infrastructure investment, and resilient property market activity. Recent economic activity data has beaten market expectations and financial deleveraging has had limited impact on the real economy.

- **Growth has been sustained by new industries:** Technology, healthcare and entertainment have supported growth in the economy even as traditional sectors saddled with overcapacity issues have lagged behind. For example - China’s digital economy grew 19% in 2016, compared with a less than 7% expansion in its GDP.

**Long term growth drivers in place**

- **GDP growth drivers are shifting from investment to consumption:** The effect of the policy change has been reflected in the strong contribution of consumption to GDP growth - 64.6% in 2016. Chinese households have a savings rate of 30%, as compared with single digit savings rate in many developed countries, indicating a solid base and sustainable trend for future growth in consumption.

- **Urbanisation could further increase consumption in the long term:** Around 57% of China’s population lives in urban areas, yet only 41% is entitled to public welfare. The state council aims to move an additional 100 million people into cities permanently through the household registration system - Hukou. Urbanisation and consumption upgrades are expected to increase demand for goods and services and help maintain economic growth levels.

---

**Service industry’s contribution to GDP has increased steadily in the past few years**

![Chart showing service industry’s contribution to GDP](chart)

**Consumption’s share of GDP growth has risen amidst China’s transition**

![Chart showing consumption’s share of GDP growth](chart)

Source: CICC, The State Council of the PRC, Bloomberg, data as of July 2017
Why invest in the Chinese equity market?

**Policy-driven restructuring**

- **Balancing the rate and quality of growth:** Policies aimed at increasing the efficiency of state owned enterprises (SOEs) are expected to remain in place, which in turn will improve their return on equity and revitalise traditional industries in the long run.

- **Addressing excess supply issues:** The deep cuts in capacity at commodity suppliers have led to a sharp rebound in commodity prices, including those of cement and steel, and improved profit margins.

- **Greater control on quasi-fiscal financing:** The scope of deleveraging has been expanded from the financial sector/system to the real economy, with a focus on SOEs and local governments. Looking ahead, SOEs’ borrowings are expected to fall, with a shift towards debt-to-equity swaps and IPOs for funding. Similar to SOEs, local governments will be subject to greater controls when issuing debt and their officials will have lifelong accountability for local government debt issues.

**Improving corporate earnings**

- **Industry consolidation** has resulted in better profitability for large companies with good fundamentals. Consolidation has also reduced overcapacity and improved competitiveness. “Strategically important” sectors and industries, which are well supported by government policies are set to gain, as are market leaders and industry champions.

- **Major indicators show an upward trend:** Revenue growth at Chinese companies has picked up, with economic activity getting back on track. Moreover net margins are improving as a result of increased capacity utilisation. Tax cuts have also helped boost corporate profitability, driving markets higher. Consensus data shows eight out of ten major Global Industry Classification Standard (GICS) sectors are seeing upward earnings revisions, and earnings growth forecasts are at their highest levels since 2010.

**Growth of cement capacity has slowed significantly as a result of government policies**

![Growth of cement capacity](source: DBS Research, Deutsche Bank Market Research, CICC, HSBC Global Asset Management, data as of July 2017)

- **Total cement capacity (LHS)**
- **Cement capacity growth rate (RHS)**

Source: DBS Research, Deutsche Bank Market Research, CICC, HSBC Global Asset Management, data as of July 2017
Why invest in the Chinese equity market?

Underappreciated by global investors

- **Low allocation in global portfolio investments:** Despite its favourable fundamentals and widely acknowledged growth potential, China continues to be under-owned by global investors. Investor preferences have resulted in developed markets generally being overweighted in many global portfolios at the expense of emerging markets such as China.

- **Attractive valuations based on historical data:** Chinese stocks are currently trading at price-to-book ratios that are well below their 10-year averages.

- **MSCI China equities have been trading at relatively low valuations since 2010** as compared with the rest of the world. This is likely due to insufficient investor confidence in Chinese markets amidst concerns about excessive volatility, government intervention in the markets and slowing growth.

Diversification benefits

- **Chinese equities have a low correlation with the rest of the world:** Chinese A- and H-share markets are made up of companies with relatively low exposure to the international markets. At the policy level, the Chinese government still imposes capital controls on the flow of currency in and out of the country, and foreign investors still have limited influence on the onshore market due to their relatively small ownership of China A-shares. This has contributed to the low correlation between the equity markets in China and the rest of the world. However, the government is slowly opening up China’s capital markets to foreign investors with new channels to access onshore equities. Chinese equities potentially offer good diversification in a global portfolio as it can help investors achieve better risk-adjusted returns during various market cycles.

China has a disproportionally small representation in MSCI ACWI

![Correlation of Chinese market to other world markets remains low](image)

Correlation calculated using monthly return in local currency from 31 August 2014 to 31 August 2017

Source: Bloomberg, HSBC Global Asset Management, data as of July 2017

MSCI indices | CN | US | EU | EM | JP | AU
---|---|---|---|---|---|---
China | 1.00 | | | | | |
United States | 0.58 | 1.00 | | | | |
Europe | 0.36 | 0.67 | 1.00 | | | |
Emerging Markets | 0.34 | 0.63 | 0.98 | 1.00 | | |
Japan | 0.45 | 0.72 | 0.74 | 0.74 | 1.00 | |
Australia | 0.33 | 0.67 | 0.69 | 0.65 | 0.57 | 1.00
How do A-share and H-share markets differ?

Investor profile
The A-share market is largely owned by retail investors, who often lack the necessary market knowledge and are easily swayed by sentiment. Therefore, A-shares tend to display greater volatility than H-shares.

Company size
A greater proportion of large-cap companies, many of which generate revenues outside of China, gives the H-share market a more mature profile. In comparison, there are a larger number of small and mid-cap stocks in the A-share market, which tend to be under-researched and often mispriced.

Sector breakdown
The H-share market is dominated by the financial sector and traditional industries, whereas the A-share market offers more investment opportunities in new economy sectors such as technology, healthcare and e-commerce.

Valuation dispersion
The A-share market has greater valuation dispersion. Attractive stocks could be significantly undervalued while junk stocks could be priced at unrealistically high levels.

A-shares are less correlated to other markets than H-shares

Source: Bloomberg, HKEx, HSBC Global Asset Management, data as of July 2017
Correlation calculated using monthly return in local currency from 31 August 2014 to 31 August 2017
One market, many opportunities

Opening up to the world

- Initiatives such as the Stock Connect programme and mutual recognition of funds have allowed greater interaction and integration between the Hong Kong stock exchange and the two major bourses in China. Northbound and southbound daily trading values have reached USD 704 million and USD 654 million (daily average in August) respectively. While the Shanghai Stock Connect allows access to China’s traditional industries, the Shenzhen Stock Connect opens up opportunities in new economy sectors such as information technology, e-commerce, healthcare and green technology.

- MSCI has recently announced the inclusion of A-shares in its major indices. The decision is of great symbolic importance although the actual impact may not be significant in the short term. With a 5% inclusion factor, the 222 A-shares to be included will account for only 0.7% of the MSCI Emerging Markets Index. However, this move has been considered by many as a formal recognition of China’s A-shares as a part of the global equity investment universe. Upon full inclusion in the near future, A-shares are expected to make up 9% of the MSCI EM Index.

Ways to access the onshore equity market

<table>
<thead>
<tr>
<th></th>
<th>QFII</th>
<th>RQFII</th>
<th>Stock Connect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility</td>
<td>Institutional investors pre-approved by CSRC and SAFE</td>
<td>All Hong Kong and overseas investors</td>
<td></td>
</tr>
<tr>
<td>Quota</td>
<td>Allocated to each institutional investor, totaling USD80.795bn</td>
<td>Allocated to each institutional investor, totaling RMB471.423bn</td>
<td>Subject to daily market quotas (RMB13bn for each stock exchange), but not aggregate quotas</td>
</tr>
<tr>
<td>Currency</td>
<td>Trade in RMB (conversion onshore)</td>
<td>Trade in RMB (conversion offshore)</td>
<td>Trade and settle in RMB</td>
</tr>
<tr>
<td>Price limits</td>
<td>+/- 10% (and 5% for stocks under special treatment)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Pros                 | 1. Broader range of products - including stocks, bonds, warrants, funds, index futures, fixed income products in the interbank-market – are available
                      | 2. Primary market participation - in IPOs, convertible bond issuances, additional share issuances and seasoned equity offerings – is possible | 1. No lock up period                    |
| Cons                 | 1. Subject to 3-month lock-up period                   | 1. Only selected A-share stocks are included
                      | 2. Participation in primary market disallowed          |                                        |

Source: Shanghai Stock Exchange, HSBC Global Asset Management, data as of July 2017

QFII = Qualified Foreign Institutional Investor Scheme; RQFII = Renminbi Qualified Foreign Institutional Investor Scheme
Why does active management work?

Cashing in on market inefficiencies and mispricing

- Majority of the participants in China’s onshore equity market are retail investors who are largely driven by sentiment. Though volatility has subsided under regulatory scrutiny in the past year, 3-year annualised volatility still remains high at 30%, compared with 18% and 10% in Hong Kong and the US respectively. This means there are often a large number of investors jumping in to purchase stocks at a substantial premium or sell at a significant discount, leading to mispricing. This is where a value investment approach comes in handy as it focuses on the long term prospects and profitability of companies, and views short-term volatility as an opportunity to buy stocks inexpensively.

Taking stock of multiple market drivers

- China’s economy is undergoing a major transformation and its markets are rapidly evolving and opening up. Against this backdrop, factors such as the government’s policy direction, regulatory changes, consumption patterns and investment trends play an important role in determining growth prospects for the economy and companies. Local expertise, in the form of experienced investment professionals, is paramount in understanding these changing dynamics, interpreting their implications correctly and taking the right action.

Implementing a disciplined investment process

- While performance of an investment is ultimately governed by a host of factors, an active asset manager can maximise outperformance through a clear, disciplined and repeatable process. A well-considered investment philosophy and process can help investors identify interesting opportunities amongst 3000+ stocks in the Chinese equity universe based on the valuations and profitability of these companies.

Managing and limiting risk

- Understanding inherent risks at various levels – market, liquidity, counterparty and portfolio – are key to achieving investment objectives in a consistent manner. Professional asset managers have the resources to set up risk management frameworks that can help control exposure to financial losses through continuous risk assessment, rigorous testing of control processes and regular oversight.

# HSBC Global Asset Management
## Chinese Equity Capabilities

<table>
<thead>
<tr>
<th>Representative accounts</th>
<th>HSBC Global Investment Funds Chinese Equity</th>
<th>HSBC China Growth Fund</th>
<th>HSBC China Multi-Asset Income Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key proposition</strong></td>
<td>Offshore focus with large-cap bias</td>
<td>High-conviction portfolio with stronger focus on small &amp; mid-cap space</td>
<td>Mixed asset with income tilt</td>
</tr>
<tr>
<td><strong>Benchmark</strong></td>
<td>• MSCI China 10/40 index</td>
<td>• MSCI China index</td>
<td>• 50% MSCI China and 50% Markit iBoxx ALBI China Offshore</td>
</tr>
<tr>
<td><strong>Approach</strong></td>
<td>• Invests in H-shares, red chips, ADRs and has the built-in flexibility to invest up to 70% in A-shares • Focused on stocks with below-average valuation for a given level of profitability</td>
<td>• Invests in both offshore and onshore (A-shares) Chinese equities, with greater exposure to the small &amp; mid-cap space • Focused on stocks with below-average valuation for a given level of profitability</td>
<td>• Multi-asset approach aims to capture China’s growth, while operating within a predefined risk budget • Aims to generate an attractive income stream</td>
</tr>
<tr>
<td><strong>Investment universe</strong></td>
<td>• H-shares • Red chips • A- and B-shares (max. 70% of NAV)</td>
<td>• H-shares • Red chips • A-shares (max. 30% of NAV) • B-shares</td>
<td>• A/B/H-shares and ADRs from 20% to 80% of NAV • Offshore fixed income in RMB and other currencies from 20% to 80% of NAV</td>
</tr>
<tr>
<td><strong>Characteristics</strong></td>
<td>• Aim for long-term capital growth</td>
<td>• Aim for long-term capital growth</td>
<td>• Aim for stable income with capital growth</td>
</tr>
<tr>
<td><strong>Fund AUM</strong></td>
<td>• USD1,615m</td>
<td>• USD395m</td>
<td>• USD446m</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Representative accounts</th>
<th>HSBC Jintrust Large-Cap Equity Securities Investment Fund</th>
<th>HSBC Jintrust Dynamic Strategy Mixed Securities Investment Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key Proposition</strong></td>
<td>Onshore large-cap stocks</td>
<td>Flexible allocation across onshore equities and bonds</td>
</tr>
<tr>
<td><strong>Benchmark</strong></td>
<td>• 90% CSI 300 Index • 10% Interbank deposit rate</td>
<td>• 50% MSCI China A-share Index • 50% China Bond New Comprehensive Index</td>
</tr>
<tr>
<td><strong>Approach</strong></td>
<td>• Focused on blue chip companies in market leading positions in different industries</td>
<td>• Asset allocates between stocks, bonds and other asset classes to capture the most attractive investment opportunities at different market stages</td>
</tr>
<tr>
<td><strong>Investment universe</strong></td>
<td>• A-share blue chips (no less than 80% of NAV)</td>
<td>• A-shares (30%-95% of NAV) • Other assets (5%-70% of NAV)</td>
</tr>
<tr>
<td><strong>Characteristics</strong></td>
<td>• Aim for long-term capital growth</td>
<td>• Aim for stable income with capital growth</td>
</tr>
<tr>
<td><strong>Fund AUM</strong></td>
<td>• USD1,061m</td>
<td>• USD142m</td>
</tr>
</tbody>
</table>

Source: HSBC Global Asset Management, data as of July 2017
Important information

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorised reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Global Asset Management and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Global Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance whilst any forecasts, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in emerging markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries in which they trade. Mutual fund investments are subject to market risks, read all scheme related documents carefully.

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

Copyright © HSBC Global Asset Management Limited 2017. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of HSBC Global Asset Management Limited.