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A STANDALONE ALLOCATION TO CHINA

BNP PARIBAS
ASSET MANAGEMENT

The sustainable investor for a changing world

SUMMARY

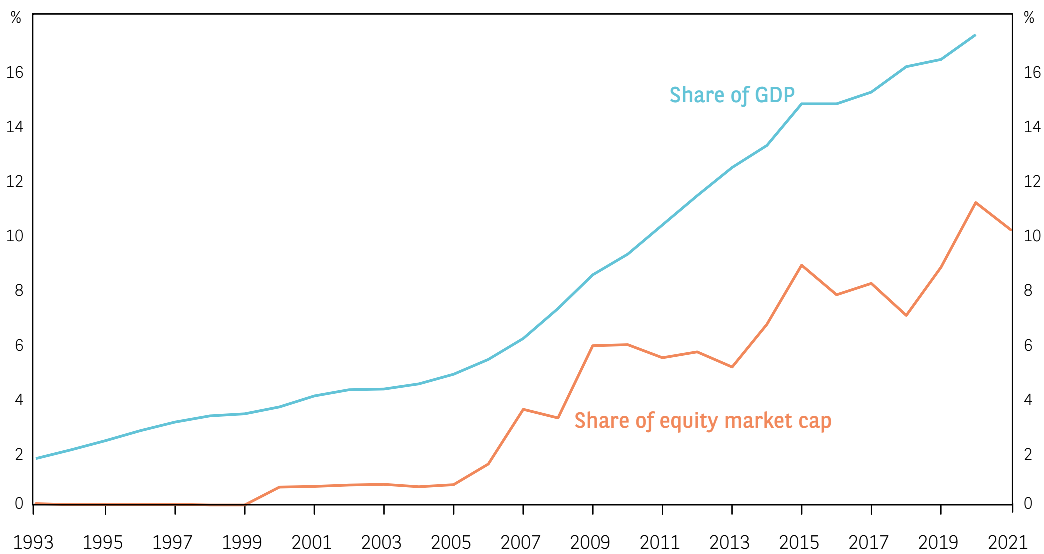
We believe that a standalone allocation to Chinese equity and fixed income can offer benefits including attractive diversification and potential excess returns for skilled active managers able to take advantage of this vast opportunity set. As China's weight in major global market indices increases and financial markets there mature, more institutional investors are looking to access Chinese financial assets via global or emerging markets strategies. We believe such an 'indirect' approach may dilute the potential to earn alpha.

Why China is worth a standalone allocation

The growth in China's GDP and equity market over the last 30 years has not been matched by its allocation in investor portfolios. Foreign investment amounts to only about 3% of China's stock market capitalisation, even though the country now accounts for nearly 18% of global GDP and 11% of global equity market capitalisation (see Exhibit 1).

The investible Chinese stock market (MSCI China IMI index) is a universe of 950 stocks with an average daily turnover of more than USD 68 million (for comparison, the S&P 500's average daily turnover is about USD 65 million). We believe it warrants not only a larger share of investor portfolios but also a dedicated allocation. Simply increasing one's exposure to emerging market equities is not adequate.

Exhibit 1 - China's share of global GDP and equity market capitalisation - China equity markets include A-share and small cap indices



Data as at 12 May 2021. Sources: World Bank, MSCI, FactSet, BNP Paribas Asset Management.

Why is the exposure to China so low?

The entire Chinese stock market, including domestic A-shares, is slightly lower than average relative to the size of the economy, at 41% versus 45% for the MSCI All Country World Index (see Exhibit 2). The investible portion, however, makes up less than half of this. While the market capitalisation of the MSCI China A-share index is half again as large as the MSCI China index, A-shares account for only about 12% of the MSCI China index's market capitalisation.

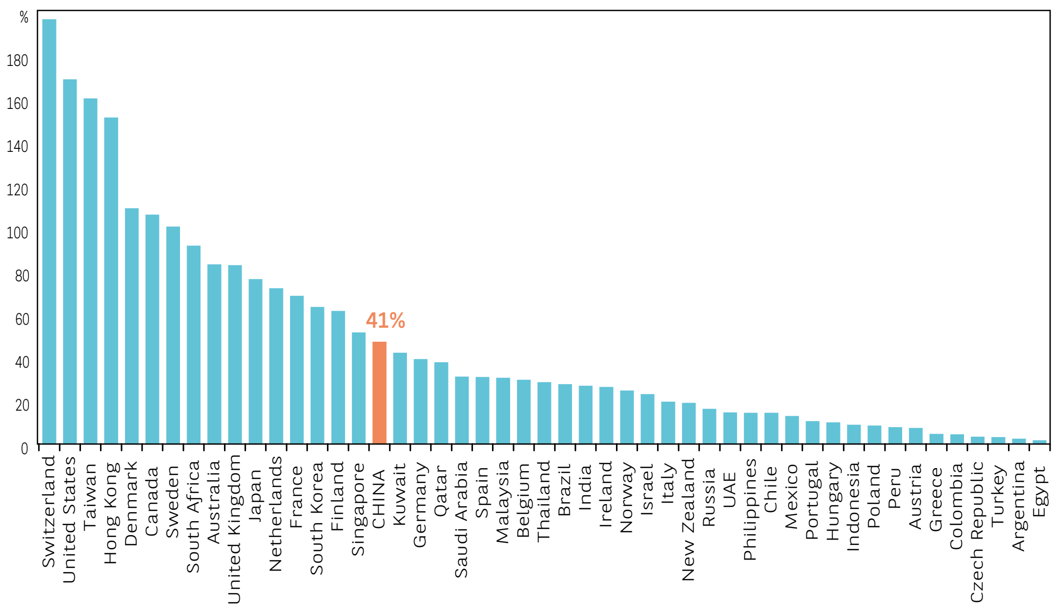
The reason why the exposure to China is so low is that historically, onshore Chinese capital markets were simply closed to international investors. Before 2002, foreign investors could not buy China A-shares. In recent years, we have seen a series of efforts by Chinese regulators to liberalise the domestic equity markets, such as the introduction of the Qualified Foreign Institutional Investors (QFII) quota in 2002 and the introduction of the Renminbi QFII in 2011. The Hong Kong-Shanghai Stock Connect platform was launched in 2014 followed by Hong Kong-Shenzhen Stock Connect in 2016. Both offer international and mainland Chinese investors the opportunity to trade securities in each other's markets.

China has been liberalising its market over the last 20 years and foreign portfolio inflows have increased in response. There are still issues, however, that limit a greater inclusion of A-shares in MSCI indices. Further increases in the weight of A-shares beyond 20% would largely depend on the Chinese authorities addressing market accessibility problems such as the short settlement cycle of China A-shares or trading holidays on Stock Connect.

We expect these issues to be addressed over time, meaning there is still huge potential for investors to benefit from the further development of the country's capital markets.

The opportunity will also come from new companies listing on the market. While the US is the leader in initial public offerings (IPOs), accounting for 53% of global proceeds raised in 2020, according to PwC's Q4 2020 Global IPO Watch, China and Hong Kong were far ahead of any other emerging market country with a 27% share.

Exhibit 2 - Equity market capitalisation as percentage of GDP

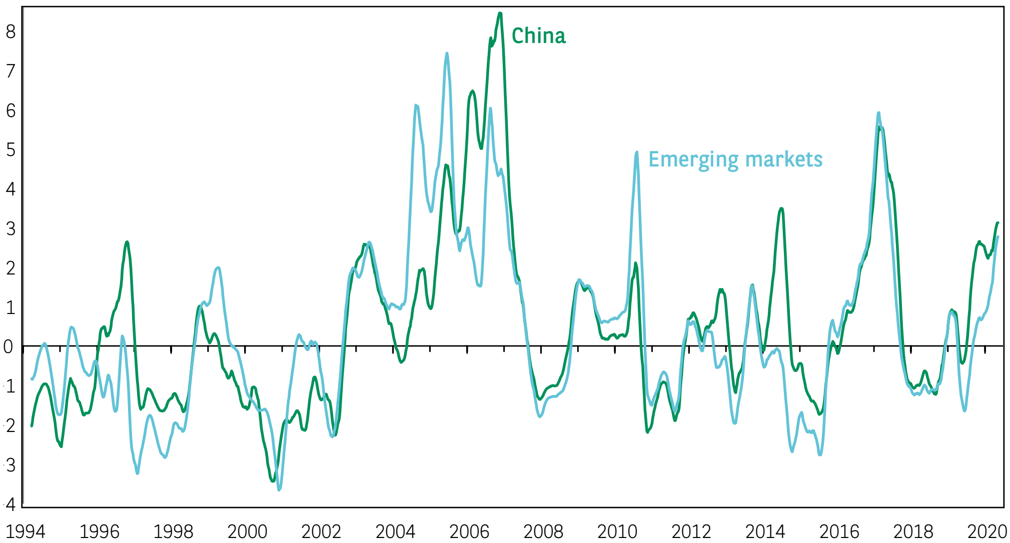


Data as at 12 May 2021. Note: China includes A-share onshore market. Sources: MSCI, FactSet, BNP Paribas Asset Management.

One reason investors shy from making single country allocations rather than regional allocations (with the notable exception of the US market) is that it can add more to volatility than it does to returns. In other words, the country allocation can lower the portfolio's Sharpe ratio. Given the size of China's market, however, this is not necessarily the case. The Sharpe ratio of the China index is not much different from that of the MSCI Emerging Markets index. It has actually been slightly higher on average (0.45 vs. 0.33) since 1994.

Moreover, given the relatively immature state of the onshore equity markets, a number of investors are concerned about finding high-quality active managers who meet their due diligence standards. A stronger regulatory landscape and rising international participation should enhance the institutionalisation of the market. When countries such as Taiwan and South Korea entered international market indices, there was a notable increase in foreign participation and investment flows, so we believe that being positioned in China ahead of this trend is the ideal choice. Today, foreign ownership of onshore Chinese equity markets is low at 2.4% compared to that of other major economies (16.2% for India, 16.8% for Japan, 32.9% for South Korea), according to IMF data.

Exhibit 3 - MSCI Emerging Markets and MSCI China index Sharpe ratios



Data as at 12 May 2021. Sources: MSCI, FactSet, BNP Paribas Asset Management.

Diversification benefits and alpha opportunities through a standalone allocation

Investors can increase their exposure to China simply via a higher allocation to emerging markets, but we believe this is not ideal.

Chinese assets have historically showed a low correlation with both developed markets and other emerging markets as China was less connected with the global economy a few decades ago and capital restrictions had previously limited cross-border flows. Besides, China has a unique political and economic management regime, meaning the market may add diversification to a portfolio.

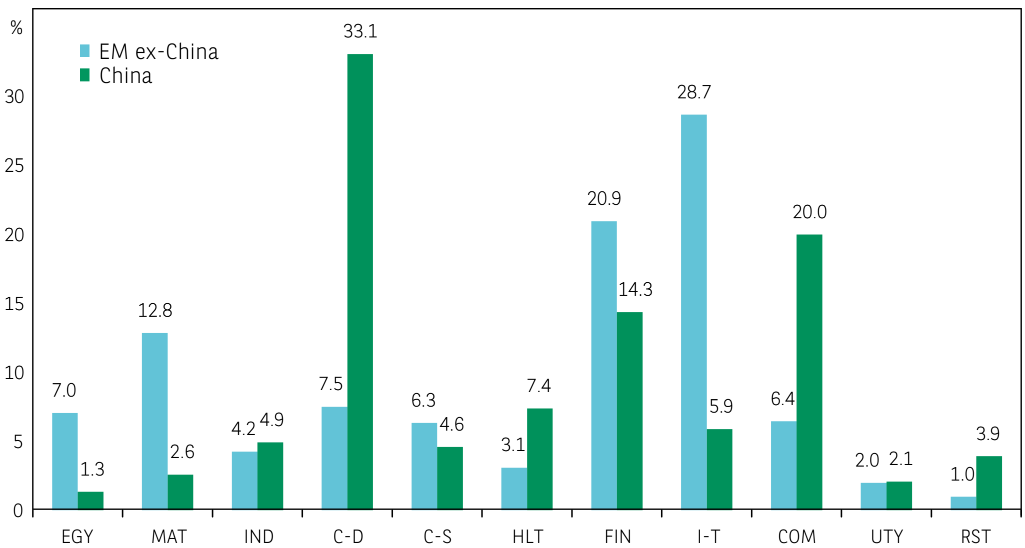
In addition to the portfolio diversification benefits, the onshore China equity markets can provide significant alpha opportunities, in our view. We see two major reasons for this:

1) Chinese equity markets have shown a large dispersion in performance between both sectors and individual stocks, so a skilled active manager can have a meaningful impact on returns by selecting winners and avoiding losers.

2) The onshore equity market is largely retail-driven. This tends to exacerbate market volatility and should create a suitable environment for experienced institutional investors to take advantage of market inefficiencies and deliver alpha.

Besides, the China and EM indices are not comparable in terms of sector composition or growth potential. As Exhibit 4 illustrates, the China index has a lower exposure to the volatile, cyclical energy and materials sectors, as well as a lower exposure to the financial sector and the accompanying credit risk, than the rest of emerging markets. These are characteristics that most investors would likely find appealing. On the other hand, the China index appears to have a far lower weighting in information technology, which could be a significant liability as the world digitalises more and more.

Exhibit 4 - MSCI index sector composition



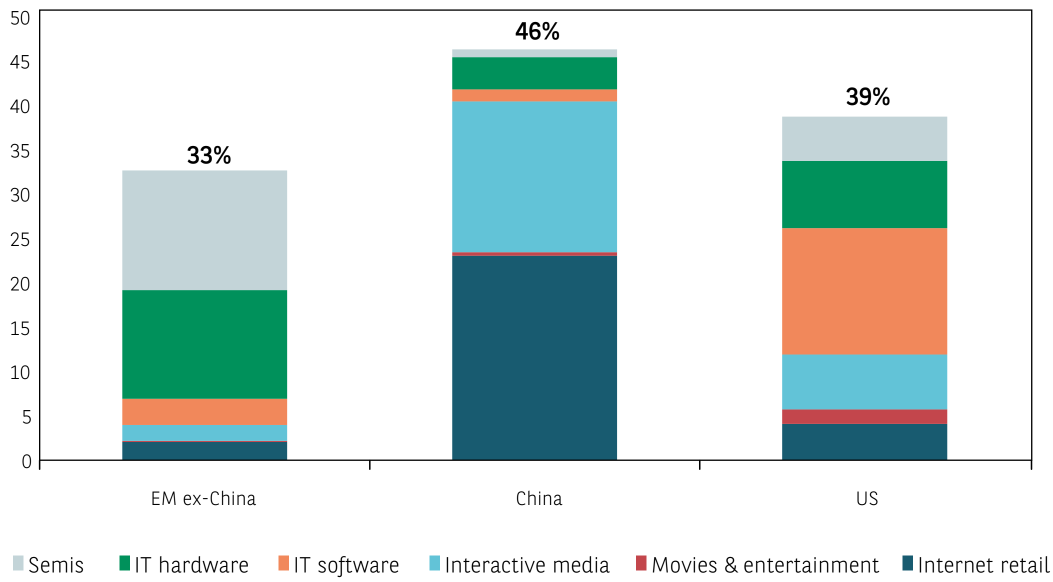
Data as at 12 May 2021. Note: Sources: MSCI, FactSet, BNP Paribas Asset Management.

The Global Industry Classification Standard (GICS) system used by MSCI to define sectors does not accurately represent the technological exposure of the indices, however. For example, internet retailers are part of the consumer discretionary sector, while internet services and streaming entertainment are part of communication services.

If one groups these industries into 'broad technology', they account for nearly half of the MSCI China index compared to just 33% for MSCI ex-China. Even this share for the MSCI ex-China index overstates the index's exposure to the newer, more dynamic parts of the market as traditional semiconductor companies make up nearly half of the weighting.

The MSCI China is distinctive in that it is the emerging markets index whose composition is most like that of the US index and shares its exposure to the most innovative parts of the economy (see Exhibit 5).

Exhibit 5 - Broad technology share of MSCI index



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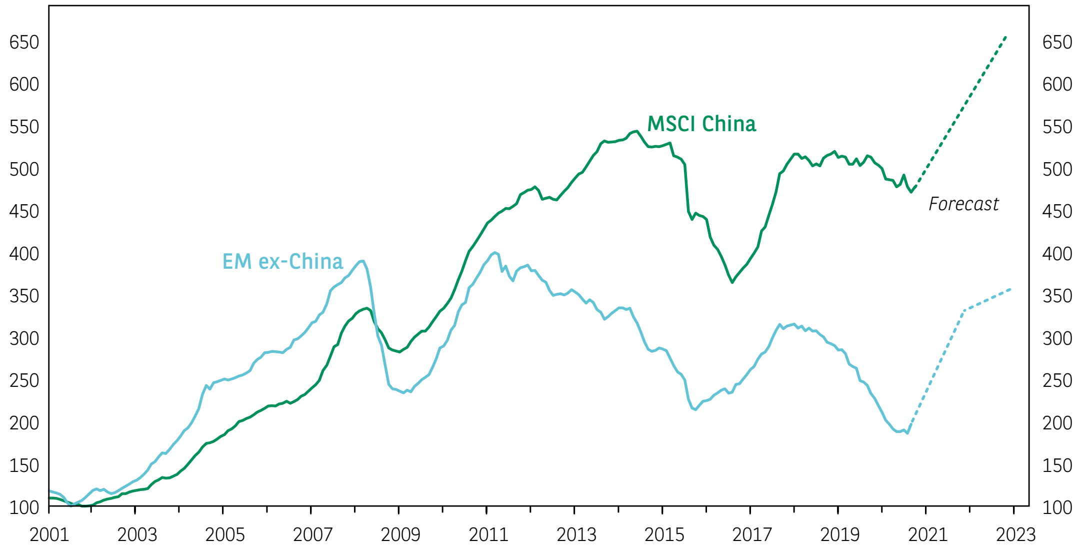
The higher weight of new technology industries in the index has a direct impact on actual and expected earnings growth. Over the last 20 years, companies in the MSCI China index have generated 7.7% annual earnings growth (in USD), while the emerging markets ex-China index has managed less than half that (see Exhibit 6). The outperformance should continue, with the long-term earnings growth rate forecast for the MSCI China at 19.2% compared with 16.1% for the EM ex-China index.

Exhibit 6 - Index EPS - Trailing 12-months and forecast



Data as at 12 May 2021. Note: Sources: MSCI, FactSet, BNP Paribas Asset Management.

Conclusion

The growth potential of the Chinese economy has long been recognised. What has changed is that its financial markets have become more and more open to foreign investors. The markets have now matured to the point where the country deserves a standalone allocation in investors' equity portfolios.

Not only is the long-term growth potential superior to that of almost any other country, the sector makeup is distinctive from that of the rest of the emerging markets. There are more companies in faster-growing new technology sectors, and fewer in volatile, cyclical and commodity sectors. The number of new listings is likely to exceed that of other markets, providing greater access to the leading companies of the future.

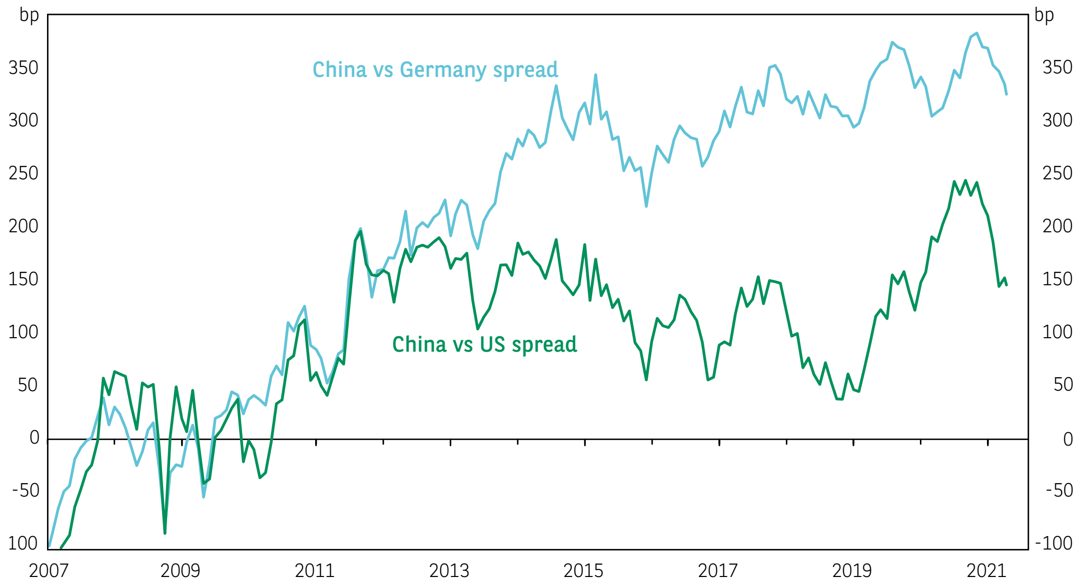
China fixed income

While the Chinese equity market has grown to represent the largest share of the MSCI Emerging Markets index, fixed income still accounts for a small percentage of major bond indices by Bloomberg, JPMorgan and FTSE Russell. The share is growing, however, with FTSE Russell the latest index provider planning to include the country's bonds in its indices. Since China is now represented in all the key global indices, it has become part of the **global** opportunity set for investors, not just an emerging markets opportunity.

Foreign investors currently hold only a limited share of what is the second largest bond market in the world, just 2.5% of a USD 16.5 trillion market (including central government, local government, financial and corporate bonds). As the index providers increase the share allocated to China in their benchmarks, billions of dollars of inflows are likely to ensue. Inflows amounted to USD 150 billion in 2020 and we expect that there may be as much as USD 200 billion in 2021. We see these inflows coming not just from institutional, but also from retail investors.

The appeal to foreign investors of the Chinese market is relatively high yields, a stable currency, and low correlations with other local currency emerging market debt. In addition, there is often a negative correlation with the domestic A-share market. The spread of 10-year Chinese government bonds vs the US and Germany has risen from about -100bp before the global financial crisis to 130bp on average over the last five years relative to the US, and to 325bp compared to German Bunds. This higher spread comes along with an A+ sovereign rating. Hedged back to the US dollar, the spread over Treasuries is currently nearly 150bp (see Exhibit 7).

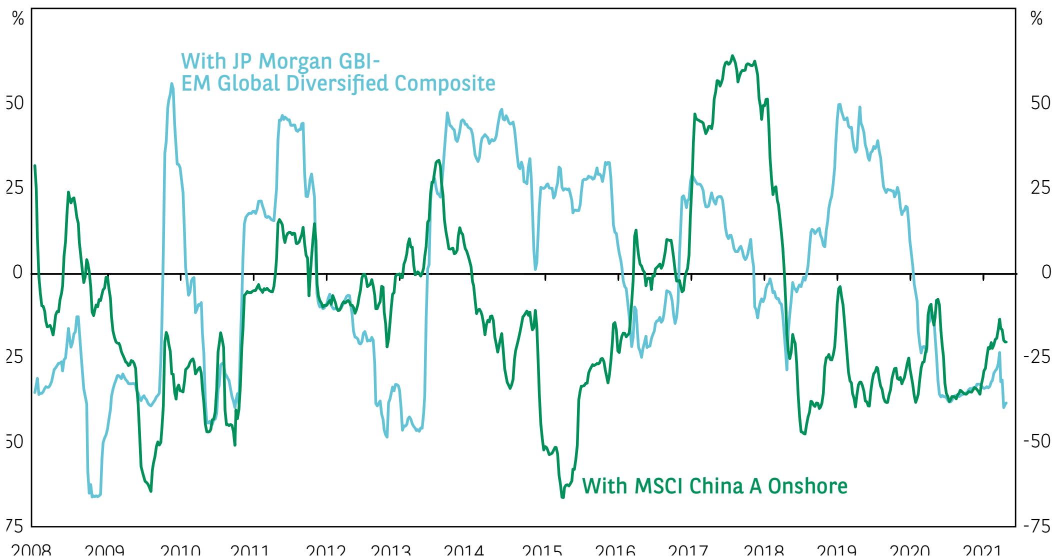
Exhibit 7 - Chinese 10-year government bond spread



Data as at 12 May 2021. Sources: Bloomberg, BNP Paribas Asset Management

Given the relatively closed nature of the Chinese economy, markets are influenced less by international macroeconomic developments. Consequently, the correlation of the bond market (as measured by the S&P China Bond index of local-currency government and corporate bonds) with other emerging markets is relatively low. The average correlation with the JP Morgan local currency emerging markets bond index has in fact been zero over the last 13 years, ranging from -50% to +50%. The correlation has been notably low since the outbreak of the coronavirus pandemic, highlighting the diversification benefits the market offers (see Exhibit 8). Chinese bonds have also seen just 60% of the volatility of the US Global Aggregate bond index over the last several years.

Exhibit 8 - Correlation of S&P China Bond index



Data as at 12 May 2021. Sources: Bloomberg, BNP Paribas Asset Management

The Chinese corporate bond market is large, but relatively under-researched. Few domestic issuers have international ratings, and domestic ratings are not directly comparable to those from international agencies. This is an opportunity, for active fund managers to identify those issues where the market is not pricing the risk associated with a bond correctly.

As always, there are risks. Political risk has not diminished significantly with the arrival of a new administration in the US. We believe, nonetheless, that the two countries will maintain a productive relationship.

Investors are understandably concerned about debt burdens. Debt has grown significantly since the global financial crisis, but the government has been addressing this. Its deleveraging programme has resumed alongside steps to remove the implicit guarantee policy for state-owned enterprises (SOEs). In the short term, this could lead to rising onshore credit default rates (albeit from historically low levels) as over-indebted and less systemically important companies are allowed to default, but it should be positive for the market in the medium to long term. We also expect policymakers to continue to resort to counter-cyclical targeted stimulus and liquidity programmes to stabilise growth and avoid systemic risks during periods of heightened uncertainty.

Regulatory and transparency-related risks centre on investment quotas and capital controls. Policymakers are seeking to attract more foreign investor participation, however, and are aiming to create a unified regulatory framework to enable a more efficient allocation and accessibility of capital. The government is also enabling international rating agencies to rate onshore companies.

A stable currency is one of the attractions for foreign investors, but at the same time, China is not exempt from the 'impossible trinity'. That is, it is impossible to combine a fixed and stable exchange rate, independent monetary policy, and free international capital flows. Until now, China has limited international capital flows, but currency controls could be loosened to allow for greater freedom in the movement of capital. Indeed, we have seen greater exchange rate flexibility employed by Chinese policymakers in recent years, including the removal of the 'counter-cyclical' factor, and we expect further currency liberalisation over time.

Given the sticky domestic client base, particularly in the higher-quality onshore bond market, trading in size or in the secondary markets can be challenging. Over time, a more diverse investor base including foreign investors with different risk and return objectives should enhance liquidity conditions.

China's bond market is the second largest in the world, but most emerging market debt investors have at most a negligible allocation in their portfolios. We believe this market offers the potential to obtain above-average, risk-adjusted returns, principally for those who have the skills and experience to analyse it.

Christophe Moulin

Christophe Moulin has over 25 years of investment experience and he has been Head of Multi Asset at BNP Paribas Asset Management since November 2017. He joined the company as Head of the Portable Alpha team in July 2008. From April 2011 to November 2017, he was Head of Flexible and Absolute Return at Theam.

Before joining BNP Paribas Asset Management, Christophe was Co-Head of a Global Macro proprietary trading desk at Société Générale between 2005 and 2008. Between 1996 and 2005, he was Global Macro alternative portfolio manager at IXIS Asset Management. He began his career in 1994 as a financial engineer for Caisse Nationale de Crédit Agricole.

Christophe graduated as an Actuary from the Institut de Science Financière et d'Assurances (ISFA) and he is based in Paris.

Daniel Morris

Daniel Morris is Chief Market Strategist at BNP Paribas Asset Management (BNPP AM) and co-head of the Investment Insights Centre. He joined our company in 2015 and is based in London.

Prior to joining us, Daniel was managing director, global investment strategist at TIAA-CREF, where he was responsible for advising clients and portfolio managers on investment strategy and asset allocation. Prior to that, Daniel was global market strategist at J P Morgan Asset Management, senior equity strategist at Lombard Street Research, and US equity strategist at Bank of America Securities.

Daniel has 24 years of investment experience. He holds a BA in Mathematics from Pomona College, an MBA from The Wharton School of the University of Pennsylvania, as well as an MA in International Economics and Latin American Studies from Johns Hopkins University. Daniel is a CFA Charterholder.

The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay.

Investing in emerging markets, or specialised or restricted sectors is likely to be subject to a higher than average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity, or due to greater sensitivity to changes in market conditions (social, political and economic conditions).

Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk.

INVESTORS' corner

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