For professional investors

UNDERSTANDING INVESTMENT OPPORTUNITIES IN CHINESE EQUITIES & FIXED INCOME

CHINA HANDBOOK

BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

CONTENTS

INTRODUCTION

China's economic development is a unique success story. With 1.4 billion inhabitants and a GDP growth of USD 13.6 trillion in 2018[1], Chinese equity markets have lagged behind the spectacular growth of the economy, given the large discrepancy between China's share of the global economy and that of investors' equity allocations. In our view, it is inevitable that this margin will close as China continues to open up its capital markets to foreign investment.

BNP Paribas Asset Management (BNPP AM) believes there is a profound investment opportunity in Chinese markets driven by:
1) The gradual acceptance of China equities / fixed income in institutional investors' portfolios;
2) The changing nature of China's economic structure, prompting the emergence of Chinese companies becoming recognised on the global stage.

In this document, we will discuss the developments in both China equities and China fixed income markets that make us believe that the best way for a long-term investor to gain exposure to the modernisation of China's economy is the following - take a long-term investment view on a number of Chinese companies which we anticipate should be future winners in their industries.

The investment opportunities in China today are too big to ignore, but the Chinese markets require local expertise to navigate its waters successfully. While a purely passive approach has limitations, we believe that exposure to the China market could benefit an investor's portfolio over the long term, by enhancing the risk-return profiles of their global portfolios.

Here is a snapshot of some key indicators

- **1.4 BILLION** ▶ China has the largest population in the world.
- **6.6%** ▶ China's GDP growth in 2018 (vs. 6.8% year-on-year [YoY] in 2017).
- **USD 12+ TRILLION** ▶ Market capitalisation of the Chinese equity markets (both China onshore and offshore markets).
- **14.8%** ▶ At 100% inclusion, China A-shares are expected to make up 14.8% of the MSCI Emerging Markets Index (vs. 3.33% in 2019).
- **USD 12+ TRILLION** ▶ China onshore rates and credit bond, making China the 3rd largest world's bond market, behind the US and Japan.
- **85%** ▶ What China's bond market represents out of the country's GDP (low relative to most developed markets).
- **59.6%** ▶ Internet penetration rate in 2018 (vs. 22.6% in 2008).
- **33%** ▶ Mainland Chinese consumers in the global luxury market in 2018.[2]

1 Source: World Bank, United States Census Bureau, as of 2019.
2 Source: Bain & Company research, 15 November 2018.

CHINA'S ECONOMIC REBALANCING TOWARDS QUALITY GROWTH

CHINA "NEW NORMAL" ECONOMY

After high-speed economic growth in the past three decades, the Chinese government has embraced slower economic growth, referring to it as the 'new normal', which not only aims at quantitative but also qualitative and sustainable growth.

China's GDP growth in 2018 was 6.6% (slightly higher than the government's initial target of 'around 6.5%' growth). In March 2019, Beijing set a GDP growth target range between 6.0% and 6.5%, down from last year's target of 6.5%.

The government aims at putting China's growth on a more sustainable path than before. The government's revised growth target reflects the economic rebalancing and the increasing focus on the quality of growth, while still maintaining the objective of achieving a 'moderately prosperous society' by 2020, though doubling GDP over the period from 2010 to 2020.

Beijing acknowledges the need for China to embrace a new growth model less reliant on fixed investments and exporting. The objective is for more economic growth to come from private consumption, services and innovation. This also implies structural reforms that China will have to undergo to address challenges arising from the past high-speed growth. The new economy transformation focuses on:
1) Supply-side and mixed ownership reform;
2) Investment to consumption growth model;
3) Industrial upgrade "Made In China 2025";
4) New sectors (Green, Technology, Media and Telecom, Healthcare);
5) "Chinese Inc. going global", Belt and Road Initiative (BRI).

Despite its transition to slower economic growth, China continues to be the largest contributor to world growth since the global financial crisis of 2008.

Exhibit 1: China is set to overtake the US economy by 2030 (Gross domestic product at market exchange rates)

2017	2018	2022 estimates	2032 estimates
US	US	US	China
China	China	China	US
Japan	Japan	Japan	India
Germany	Germany	Germany	Japan
France	UK	India	Germany

Source: Bloomberg, Centre for Economics and Business Research, as of 2019.

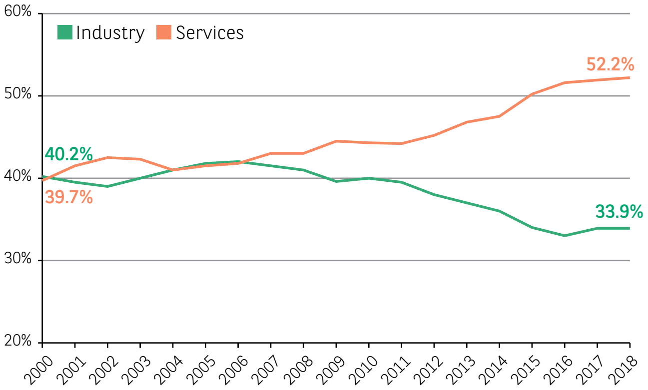
ECONOMIC REBALANCING TOWARDS CONSUMPTION

Slowing growth implies lower corporate profits and greater pressure to improve efficiency. Against this backdrop, the rebalancing of the economy towards consumption is crucial.

From a production perspective, the tertiary industry, accounting for 52.2% of total GDP vs. 43% in 2008 (Exhibit 2), grew at an impressive rate of 21% year-on-year in 2018. This suggests that the new economic sectors were gaining traction. From an expenditure perspective, net exports detracted from GDP growth by - 8.6% in 2018, continuing a trend of negative contribution to GDP growth since 2009.

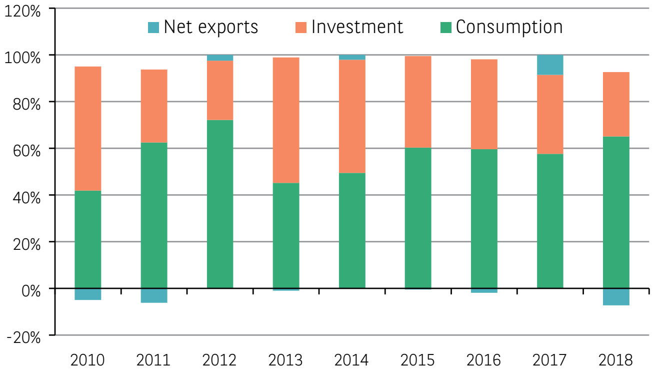
China had switched from export-led to domestic-led growth since the Great Financial Crisis. Within the domestic sector, total consumption contributed to over 75% of GDP growth vs. 45% in 2010 (Exhibit 3).

Exhibit 2: The services sector now represents more than half of China's GDP



Source: Wind, UBS, as of 16 January 2019.

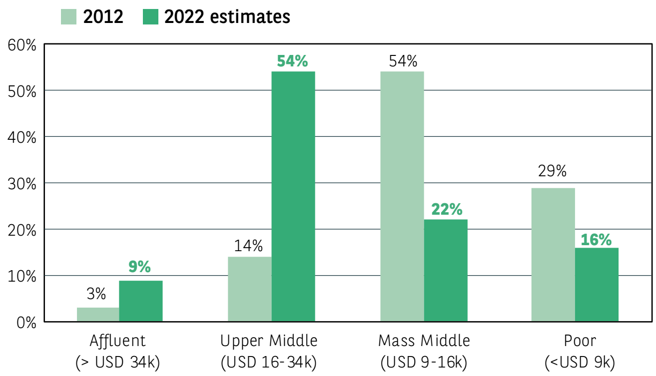
Exhibit 3: Consumption now leads China's economic growth (China's GDP components by expenditure)



Source: Wind, UBS, as of 16 January 2019.

With growth slowing only gradually, progress has been made, helped by the fact that China's consumption is supported by stable income growth (Exhibit 4). The wage share of GDP continues to go up, reversing the two-decade declining trend. Such a recovery is also in sharp contrast with the OECD countries where on average the wage share has been flat for several years. Besides, overseas spending by China has increased in recent years as more people joined the ranks of the middle class. Today, China accounts for over 20% of global outbound tourism (Exhibit 4), which is twice as much as that of the US.

Exhibit 4: China's expanding middle class
(2012 vs. 2022)



Source: McKinsey Quarterly, 2013, BNPP AM, as of December 2017. Note that data are annual income.

CHINA'S BELT AND ROAD INITIATIVE (BRI)

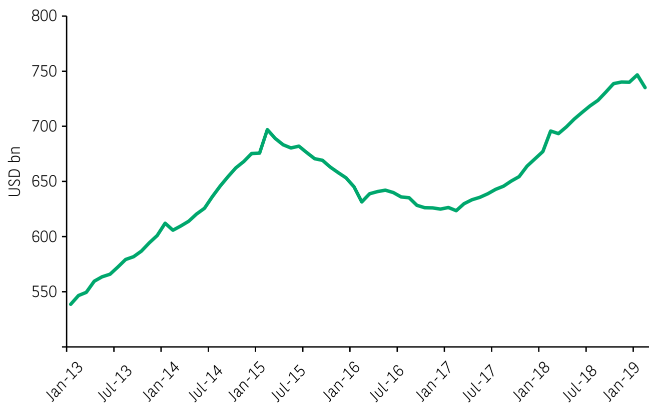
The Belt and Road Initiative (BRI) is a project connecting China's old economy plagued by excess capacity (steel, coal, construction, heavy industries and engineering) to other low- and middle-income developing countries in Central and Southeast Asia, the Middle East, Africa and Eastern Europe. It is designed to enhance the orderly free flow of trade and the efficient allocation of resources. Over land routes, it includes the Silk Road Economic Belt, and for sea routes, the 21st Century Maritime Silk Road.

Since October 2017, BRI embraces various strategic objectives:

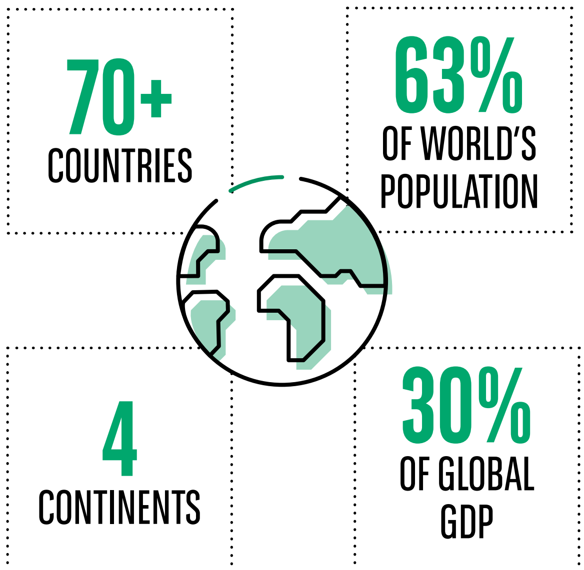
- **Ease China economic transformation** by developing new markets for industries in overcapacity while encouraging innovation toward sustainability (Green Belt and Road);
- **Raise the share of RMB** in trade, overseas investment, financing by development banks, Chinese policy banks and commercial banks;
- **Reinforce China's role on the geopolitical stage** by promoting political cooperation and rallying countries around a common development project.

BRI is a long-term project which will offer various investment opportunities for corporates. At the initial stage, the main focus is on infrastructure, logistics, energy, commodities, and environment. At a later stage, the focus will be on new industries and consumption markets such as technology, media, telecommunications, real estate, consumer goods brought by improved infrastructures. Chinese exports continue to find new markets, as China's exports to BRI countries continued to accelerate, exceeding USD 700 billion as of March 2019 (Exhibit 5).

Exhibit 5: China's exports to BRI countries continued to rise



Source: CEIC, BNPP AM Asia, as of May 2019. Data include 62 countries as of 2017, series in 12-month rolling sum.



CHINA'S GROWTH BEYOND THE MIDDLE-INCOME TRAP

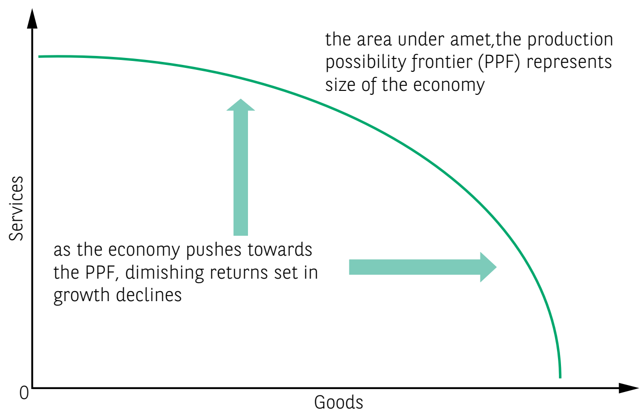
BY CHI LO, BNPP AM SENIOR ECONOMIST GREATER CHINA, AS OF 24 JULY 2019

- **China could avoid falling into the middle-income trap if it could break the economic constraints of population, capital and productivity on growth. But can it realistically do that and what will it look like in the post-middle-income environment?**
- **Consumption-led growth and industrial upgrading will be two of the key emerging themes in China's structural change over the next 30 years when President Xi Jinping's "Chinese Dream" is supposed to yield some tangible results.**
- **The structural switch from quantity to quality growth has just begun. The ultimate question is who will benefit from China's transition from being the world's factory to being a high-income, high-tech and consumption-led economy?**

China's annual GDP growth has fallen from double-digit rates between 1980 and 2012 to around 7% since President Xi Jinping took office in 2013. Growth is now expected to fall below 6% in the coming years. This declining trend seems to vindicate warnings of the dreaded middle-income trap – the tendency of fast-growing developing economies to revert to a much weaker growth trajectory, and stagnate when per capita income approaches the upper bound of the middle-income range of between USD 6 000 and USD 12 000 a year, according to the World Bank. China's per capita income in 2018 was already USD 10 200.

Economic growth is a function of the two factors of production – labour/population and capital – and a residual factor – productivity. When a country grows towards its production possibility frontier (PPF)[3] which defines the size of the economy, diminishing marginal returns set in (Exhibit 6). If there is no growth in productivity, overall economic growth will stagnate and eventually decline.

Exhibit 6: Production possibility frontier



Source: BNPP AM Asia, as of 24 July 2019.

GROWTH CONSTRAINTS – RELAXED

Whether China can break out of the middle-income trap and move to a high-income economy depends on its labour, capital and productivity constraints. Relaxing these constraints can increase the size of the economy. What is little known about China's ageing population problem is that it may not bite for another 20 years. So, labour may not be a growth constraint as commonly believed.

There are natural demographic dynamics for expanding China's labour force to counteract its contraction[4] under the prevailing static framework. China can easily find more than 200 million workers in the next 20 years to offset the expected loss of 200 million workers between 2030 and 2045 through urbanisation and changes to the retirement and regional migration policies[5].

Furthermore, if China could boost its 68.4% labour participation rate to match Japan's 79%, for example, its labour force would increase by 26% (or 162 million). Successful industrial restructuring will lead to higher labour participation by increasing the incentive to work longer to take advantage of new opportunities offered by the private sector. Any change in the population policy that can boost the birth and urbanisation rates will add to these forces. Crucially, industrial migration towards inland China (Exhibit 7) will also add to growth by tapping cheaper resources and spreading income growth more evenly across the country[6].

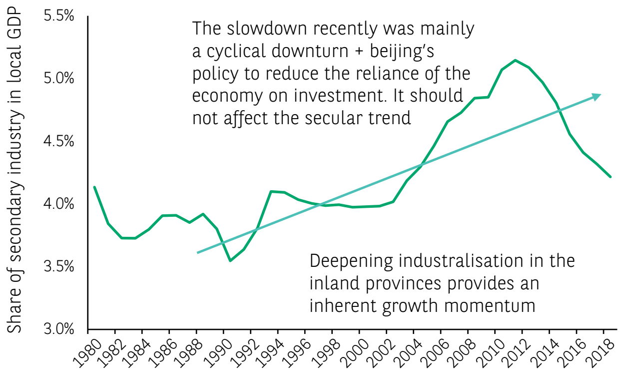
3 A production possibility frontier is a curve that shows all the possible combinations of output for two products that can be produced using all factors of production, where the given resources are fully and efficiently utilised.

4. There were 250 million 0-15 year-olds in 2018. They will be in the labour force in 16 years. If we assume the urban/rural distribution of this age cohort follows the national distribution, where 41% of the population is rural, in the next 16 years these 100-million-plus (250 x 41%) people can be urbanised. Further urbanisation of the adult rural population (15-64 years old), estimated at 402 million in 2018, will augment the labour force in the coming years. Assuming half of this population was aged between 15 and 30 in 2018, there will be more than 200 million of the rural working-age population that can be urbanised in the next 20-plus years.

5 See "Chi on China: What Don't We Know About China's Demographic Pains?" 22 May 2019.

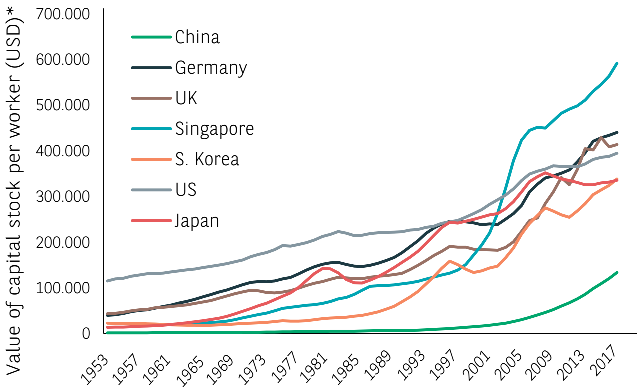
6 See "Chi on China: Progress on China's Structural Rebalancing and Reverse Migration", 8 November 2017.

Exhibit 7: Industrialisation migrating inland



Represented by Gansu, Guizhou, Qinghai, Shaanxi, Guangxi, Sichuan, Yunnan, Henan, Hubei, Hunan, Jiangxi. Source: CEIC, BNPP AM Asia, as of 24 July 2019.

Exhibit 8: China's capital stock accumulation is still in a catch-up process

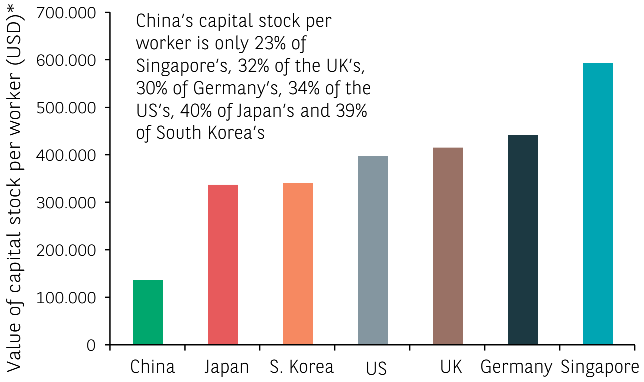


* In purchasing power parity terms. Source: Penn World Table 9.1, BNPP AM Asia, as of 24 July 2019.

Capital also does not seem to be a growth constraint for China in the medium to long term, despite the existence of excess capacity. China only started building up capital in the late 1980s, whereas most of the other major economies started in the 1950s (Exhibit 8). Even after 40 years of catching up, its capital stock per worker is still significantly less than that of the major economies and its Asian peers (Exhibit 9).

There is a conundrum that China suffers from under-investment as well as excess capacity[7]. The coexistence of these two conflicting forces lays bare a serious structural flaw of capital misallocation. It argues that China's economic inefficiency was not due to too much investment but to the state sector's soft budget constraint that misallocated capital to a few giant, inefficient state industries. They create excess capacity that has dominated the economy and stymied private-sector "animal spirits", resulting in under-capitalisation in other parts of the system.

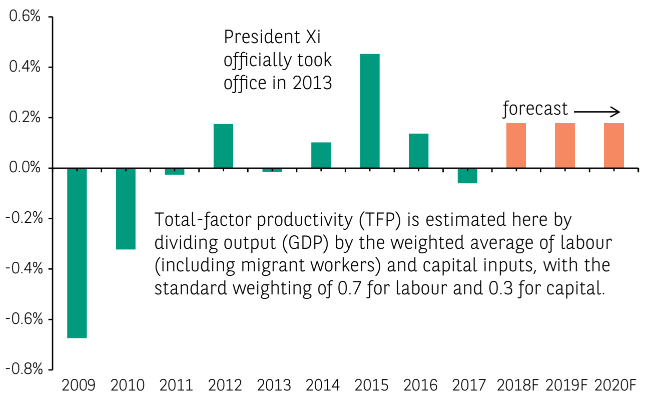
Exhibit 9: China is still under-invested (2017)



* In purchasing power parity terms. Source: Penn World Table 9.1, BNPP AM Asia, as of 24 July 2019.

Meanwhile, China's total factor productivity (TFP)[8] growth seems to be recovering from the decline in recent years (Exhibit 10) under President Xi's "new normal" policy, which aims at keeping GDP growth in a moderate 6.0% - 7.0% range, implementing structural reforms and paring debt. Previous debt-fuelled excess investment led to sluggish or decline in productivity growth. The new normal policy has shown some initial success, with rising marginal efficiency of debt-financing (Exhibit 11) implying an improvement in the quality of GDP growth.

Exhibit 10: Estimated total factor productivity growth



Source: CEIC, BNPP AM Asia, as of 24 July 2019.

7 See "Chi on China: The Conundrum of China's Excess Capacity", 14 September 2016.

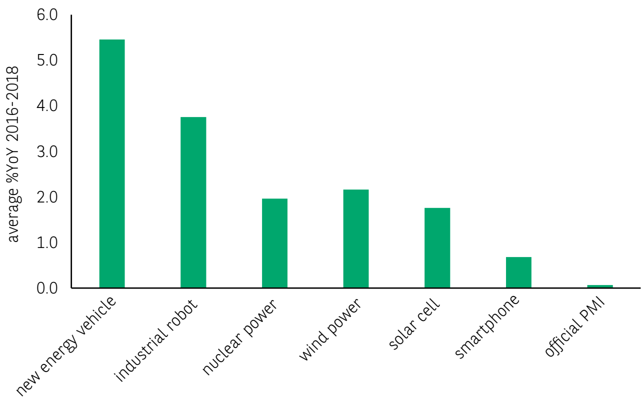
8 Total-factor productivity (TFP) is the amount of output produced by the combined inputs of labour and capital. It is estimated here by dividing output (GDP) by the weighted average of labour (including migrant workers) and capital inputs, with the standard weighting of 0.7 for labour and 0.3 for capital.

The aim of the "Chinese Dream" is to move the economy into high value-added, high-tech production through manufacturing and industrial upgrading. Already, the growth of high-tech industries has significantly outperformed overall economic growth (Exhibit 12). China's aim to become a technology powerhouse by 2050 should help raise productivity growth.

Exhibit 11: Marginal efficiency of debt-financing improves

In purchasing power parity terms. Source: Penn World Table 9.1, BNPP AM Asia, as of 24 July 2019.

Exhibit 12: Output growth of high-tech industries compared to overall manufacturing growth



Source: CEIC, BNPP AM Asia, as of 24 July 2019.

ESCAPING THE MIDDLE-INCOME TRAP

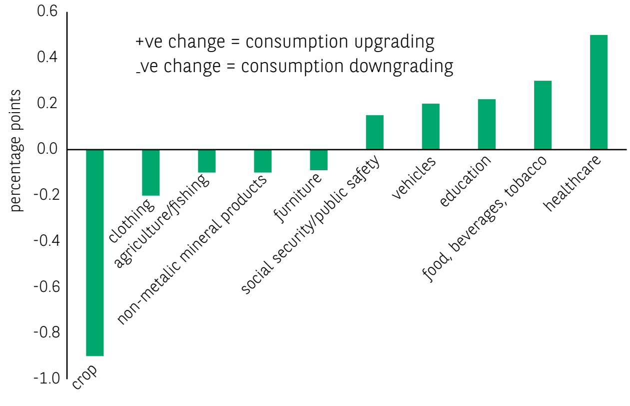
Assuming labour does not become a growth constraint for another 20 years, and that capital continues to accumulate and productivity growth revives under the new technology-focused development policy, China's PPF can be pushed out, i.e. the size of China's economy can be expanded. Even if China's per capita GDP grows by an average of only 5.0% a year for the next decade, its per capital income will breach the USD 12 000 middle-income threshold by 2028 and make it a high-income country.

Empirical evidence shows that a typical economy's propensity to consume continues to rise from the USD 6 000 to USD 12 000 per capita income levels, with the consumption pattern moving into higher value-added goods and services, such as mobile phones, cars, tourism and personal services. Above the USD 12 000 level, consumer demand will move into even higher value-added goods and services, including education, healthcare, financial services and assets[9]. Hence, the upgrading of consumption and industries will be two of the key emerging themes for China's structural change in the post-middle-income world. The next question is, which industries/sectors will benefit from this new China economy?

THE FUTURE WINNERS

Data from a recent industry study[10] gives us some basis for assessing the major beneficiaries. Chinese consumers have been upgrading their demand for goods / services alongside income growth since the turn of the millennium. For example, total consumer spending on healthcare rose by 5ppt to 11% between 2000 and 2014, but consumer spending on crops fell by 9ppt to only 5% in the same period (Exhibit 13).

Exhibit 13: Changes in share of consumer spending between 2000 and 2014

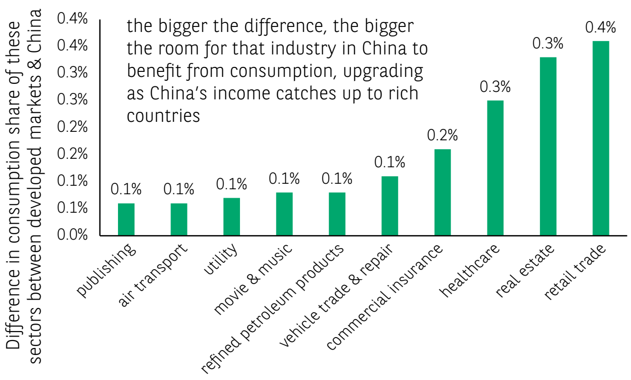


Source: Standard Chartered, BNPP AM Asia, as of 24 July 2019.

9 See "China After the Subprime Crisis: Opportunities in the New Economic Landscape", pp. 129-136 Chi Lo, Palgrave Macmillan, 2010.
10 "China – Looking Beyond the 'New Economy'", Standard Chartered Global Research, 4 December 2018.

As China moves towards a rich country status, its consumption pattern should also converge to that of a developed country. So, comparing China's consumption share in various goods and services with those of the developed countries (including the US, the UK, France, Germany, Japan and South Korea in the study here) should give us some clues about which industries will play catch-up. Basically, the larger the gap, the bigger the room for that industry in China to benefit from consumption upgrading (Exhibit 14).

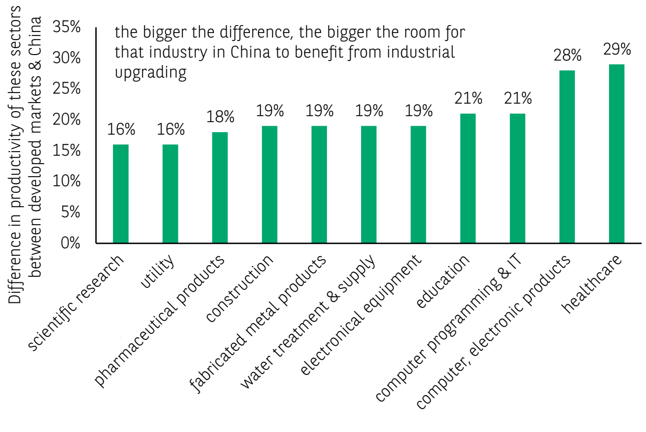
Exhibit 14: Top 10 industries expected to benefit from consumption upgrading



Source: Standard Chartered, BNPP AM Asia, as of 24 July 2019.

Meanwhile, those industries with greater potential to climb the value chain through technological innovation will benefit more from industrial upgrading. Comparing the productivity of Chinese industries with that of developed countries should give some clues for that assessment. The bigger the productivity difference, the bigger the room for that Chinese industry to gain from industrial upgrading (Exhibit 15).

Exhibit 15: Top 10 industries expected to benefit from industrial upgrading



Source: Standard Chartered, BNPP AM Asia, as of 24 July 2019.

THE REAL CHINA GROWTH STORY

The Chinese economy is far from mature, unlike most players see it. Structural reforms are crucial for pushing China's long-term growth potential beyond the current PPF. Certainly, the day of 10%+ Chinese GDP growth are over. This is inevitable. But there are good reasons to argue that China's real growth story of shifting output from quantity to quality has just begun.

Investment implications

Our Greater China equities team sees significant growth opportunities for leading companies in sectors such as healthcare, education, travel and catering. A number of these domestic winners are now emerging as multinational corporates. This will likely only accelerate in the next 5 to 10 years. **More details are provided in the next section.**

THREE STRUCTURAL TRENDS ARE DRIVING LONG-TERM INVESTMENT OPPORTUNITIES IN CHINESE EQUITIES

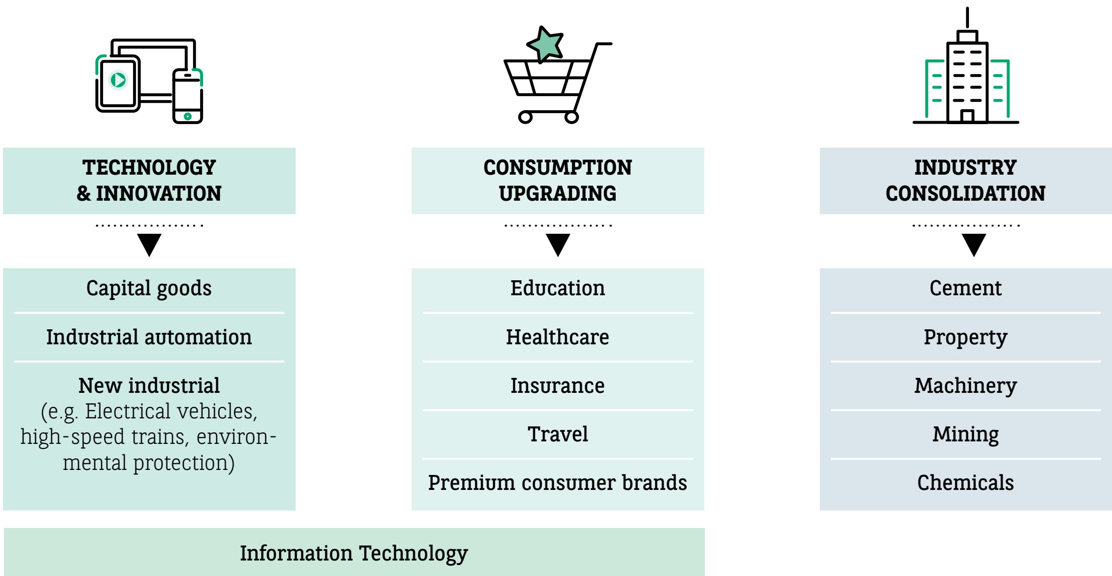
We believe the following investment opportunities will continue over the next few years as the sectors benefitting from the following three structural trends are positioned for sustainable growth:

1. **Technology innovation:** China has begun to shift from cheap labour-based manufacturing towards medium to high-end manufacturing. This is further supported by the size of the domestic market, higher R&D spending and a vast talent pool.

2. **Consumption upgrading:** We see significant growth opportunities for leading companies in sectors such as healthcare, education, travel and catering, and a number of these domestic winners are now emerging as multinational corporates, supported by rising household incomes, low household debt and more diversified consumer profiles – and this will likely only accelerate in the next five to 10 years.

3. **Industry consolidation:** Industry consolidation in China has been occurring in recent years driven by regulatory tightening on new capacities, environmental cost pressures, higher financing costs, upgrading of industrial structure and consumption upgrading. We believe this trend has longer to run in a slowing macroeconomic environment, and the emergence of leading companies in various sub-sectors should provide attractive investment opportunities.

Exhibit 16: Portfolio strategy of BNPP AM Greater China equities team over the long term



Source: BNPP AM, as of July 2019.

TECHNOLOGY & INNOVATION

China: From an innovation "sponge" to an innovation leader

China has emerged as a global driving force in innovation and its innovative capabilities are growing faster than is generally acknowledged. The country has evolved from an innovation 'sponge' – absorbing and adapting global technologies and knowledge – to an innovation leader.

Innovation is an imperative for China, as its labour force is no longer growing and the return on fixed asset investment is declining. China is focusing on four areas of innovation[11]:

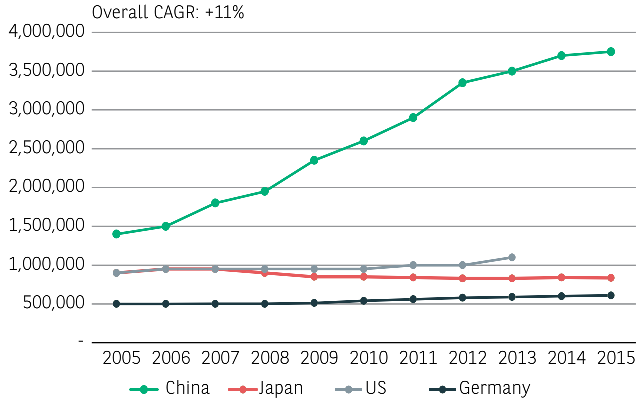
1) **Efficiency-driven:** broad manufacturing ecosystem (suppliers, labour, infrastructure);

2) **Customer-focused:** large domestic market for fast commercialisation;

3) **Engineering-based:** government creates local demand, favours learning;

4) **Science-based:** swiftly increasing, low-cost R&D capacity.

Exhibit 17: China has the highest number of R&D personnel globally (3 times higher than the US)



Source: UNESCO, as of 16 January 2018. R&D: Research & Development. CAGR: Compound Annual Growth Rate.

Here are some astonishing numbers[12] corroborating the fact that the common perception of China as a follower needs to change:

- With 2.1% of its GDP, China has spent more on research and development (R&D) than the European Union since 2014, while the pace of spending is accelerating at a much faster pace than in the US (2.8% of GDP)[13]. Over the last decade, the number of R&D personnel in China has increased by 11% a year to over 3.8 million in 2017, which is the world's largest pool of R&D personnel (Exhibit 17).

- China has become an innovator that has helped to redefine many markets, particularly in the areas of social pastimes, entertainment and advertising. In particular, China has become a strong innovator in consumer electronics and construction equipment. Alipay is China's most popular mobile payment platform. With over USD 6 trillion of transactions, Alipay users globally are as many as 520 million, representing 2.5 times Paypal's active users in the world.

- Although China initially grew to become a technology powerhouse by following the path of the US technology industry, it is now home to four of the world's ten largest internet and technology companies – Alibaba, Baidu, Tencent and Xiaomi.

- Despite some current obstacles to innovation (e.g. slow regulatory processes and weak intellectual property protection), China has grown faster than expected. A rapid increase in China's base of engineering talent[14], and the continued strength of the government's investment commitment to make engineering-based companies effective innovators in the future should accelerate China's advances in innovation. Today, it is estimated that 2.8 million of science & engineering graduate every year, which represents five times the levels of US graduates. This represents a significant opportunity to invest in Chinese companies driving this trend.

11 Source: McKinsey Global Institute, as of October 2015.
12 Source: OECD, UBS Research, as of 13 September 2017.
13 Source: NSB's Science and Engineering Indicators 2018 report, as of 2017.
14 Source: UBS Research, as of 13 September 2017.

CONSUMPTION UPGRADING

From quantity to quality in consumption upgrading

Robust income growth, a fast-expanding middle class and consumption upgrades are reinforcing strong demand for higher-quality branded products and services. We expect private consumption growth to remain strong, with a gradual shift towards discretionary and services/experience-related consumption, facilitated by a mushrooming e-commerce infrastructure.

Shift in consumption patterns

Faster income growth allows for a quicker steepening of the penetration curve in many categories, as well as a shift in consumption patterns that is occurring in three main ways:

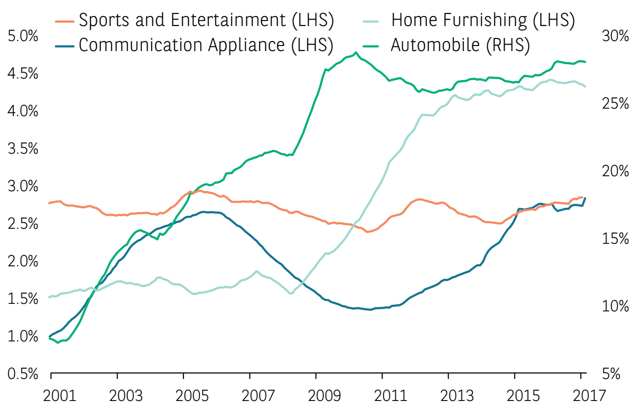
1) from staples to discretionary,

2) from mass to premium, and

3) from goods to services/experience-related purchases.

Overall consumption growth has continued to outpace that of investment growth, indicating further progress on rebalancing China's economy.

Exhibit 18: The rising share of discretionary spending



Source: CEIC, Morgan Stanley Research, as of 13 November 2017.

E-commerce: better infrastructure, easier credit

Several factors explain the impressive online sales in China:

- **Better infrastructure:** more internet access/smartphones, rapid expansion of e-payments and improving logistics network mean households have better access to e-commerce. Internet penetration in China rose from 34.0% in 2010 to 59.6% in 2018.

- **Financial innovation:** consumer credit has become more easily available to younger consumers who tend to be more eager to borrow to spend.

While growth has been impressive, China's total consumption is still one-third that of the US, meaning there is considerable further potential for spending on services and by rural consumers. Services accounted for 68% of US household consumption in 2016, but stand at only 49% in China, where rural populations' spending is lagging. Rural Chinese represent 43% of the total population, but only account for 22% of total household consumption, so boosting both services and rural consumption is crucial.

Our Greater China equities investment team expects private consumption growth in real terms to remain strong. The labour market remains relatively tight and household income growth should continue to improve. Consumption in China should become an increasingly important driver of aggregate growth, presenting significant opportunities to invest in the companies driving this trend.

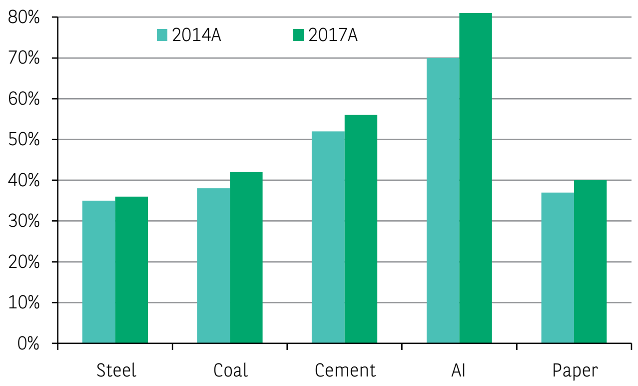
INDUSTRY CONSOLIDATION

Wave of industry consolidation boosting profits in China

Industry consolidation in China has been occurring in recent years both inside and outside overcapacity sectors, as the country's structural economic rebalancing and government supply-side policies continue.

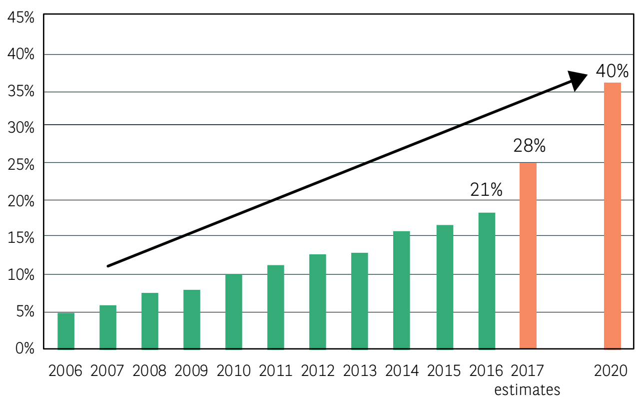
Consolidation is increasing at an accelerating pace, particularly in the overcapacity sectors such as mining and materials. One example in the overcapacity steel sector was Baoshan Iron & Steel Co.'s acquisition of Wuhan Iron & Steel Co. in 2016, to form the world's second-largest steelmaker after Europe's ArcelorMittal. In 2017, in the cement sector, China National Building Material (CNBM) merged with rival China National Materials (Sinoma) to form the world's largest cement maker and cement plant builder.

Exhibit 19: The increasing consolidation in China's materials sectors (top 4 players' market share)



Source: Wind, China coal Association, Digital cement, Antaike, Goldman Sachs Global Investment Research, as of 12 Dec. 2018.

Exhibit 20: Market share of top 10 property developers



Source: Shangshi Consulting, Goldman Sachs Research, BNPP AM, as of 18 April 2017.

The wave of consolidation is now also washing far beyond China's overcapacity sectors into consumer and services industries. Examples include car dealers, paper producers, Chinese liquor companies, brewers, budget hotels, air conditioning manufacturers, e-commerce and insurance. For instance, China Lodging Group acquired the boutique operator Crystal Orange Hotel Holdings in 2017.

Three principal reasons underpinned the current wave of consolidation:

1. **Government actions to rein in the risk from rising debt:** Moving away from investment-led growth has been one of the factors leading to overcapacity issues. China's materials sectors have been the areas most affected by debt and excess capacity. Beijing is making notable efforts to remove excess capacity in the coal and steel sectors through supply-side reforms initiatives. Consolidation can help companies boost their earnings, regain their pricing power and reduce their debt-servicing burdens.

2. **More stringent environmental protection rules:** Strengthening environmental protection measures have also caused closures / exits of a large number of firms in environmentally-sensitive industries.

3. **With China's economic rebalancing, technology advances have made market leaders increasingly dominant in knowledge-intensive industries.** Clear policy measures to encourage R&D, innovation and promote advanced manufacturing, tend to favour industry leaders that have already acquired a large market share given their existing technological advantages.

This consolidation trend is in line with the government focus to move from quantity of growth to quality of growth. One side-effect of consolidation could be an ongoing slowing in fixed-asset investment, but that may prove a short-term setback on the road toward longer-term economic benefit.

ACCESSING CHINESE MARKETS

CHINA EQUITY MARKETS

The process of accessing the Chinese equities market remains complex and unclear. It is critical to understand the accessibility constraints so as to make an informed decision when evaluating a potential investment in Chinese equities.

China: one of the world's largest equity markets

The Shanghai and Shenzhen Stock Exchanges opened in December 1990 as part of Chairman Deng Xiaoping's 'Reform and Open Up' initiatives. At the opening, the markets were small, listing only eight names with a market capitalisation of about USD 500 million. Today, no less than 3 600 companies are on these two Chinese exchanges, with a total market capitalisation of more than USD 9.3 trillion (as of 31 March 2019). Adding the Hong Kong Stock Exchange, the three exchanges tend to be grouped in the 'Greater China' category, and its total market capitalisation exceeds USD 12 trillion.

Navigating share classes

While there is no restriction in investing in the Chinese offshore equities market (e.g. Hong Kong, US American Depositary Receipts (ADRs), Taiwan, Singapore), gaining access to the China A-shares market has historically not been so straightforward.

In the past, Chinese regulators restricted foreigners' access to Mainland equity markets. Before 2002, foreign investors simply could not buy China A-shares.

In recent years, we have seen continuous efforts by China's regulators to liberalise the domestic equity market, as illustrated below:

- 2002: introduction of the QFII programme.
- 2011: introduction of the Renminbi QFII (RQFII) scheme
  For both QFII and RQFII, licensed institutions are now able to apply for a quota, and when granted, can invest in China A-shares up to a pre-determined limit. These schemes have strict quota limitation as well as lock-up and repatriation restrictions, which is relatively uncommon in developed markets.
- 2019: The QFII quota doubled to USD 300 billion in the first QFII quota expansion since 2013.

Some constraints still remain to invest through QFII/RQFII:

- Applications need to be submitted and approved for a licence by the China Securities Regulatory Commission (CSRC)

Exhibit 21: Chinese alphabet of share classes

	SHARE CLASS	INCORPORATION OF COMPANY	EXCHANGE TRADED	QUOTED CURRENCY	ACCESSIBILITY
CHINA ONSHORE	A Shares	Mainland China	Shanghai Stock Exchange (SSE) Shenzhen Stock Exchange (SZSE)	CNY	Available to non-Chinese investors via the Stock Connect program – daily investment limitations apply; Large institutions may access with QFII or RQFII
	B Shares	Mainland China	SSE SZSE	USD HKD	All investors may access; highly illiquid
CHINA OFFSHORE	H Shares	Mainland China	Hong Kong Stock Exchange (HKEX)	HKD	All investors
	N Shares	Off-shore	NYSE NASDAQ	USD	
	P Chips	Off-shore, non-state owned	Hong Kong Stock Exchange (HKEX)	HKD	
	Red Chips	Off-shore, state owned	Hong Kong Stock Exchange (HKEX)	HKD	
	S Chips	Off-shore, non-state owned	Singapore Exchange	SGD	

Source: Wind, FactSet, BNPP AM, as of 31 March 2019.

QFII: Qualified Foreign Institutional Investor. RQFII: RMB Qualified Foreign Institutional Investor.

- Once a licence is granted, an application needs to be submitted for an investment quota
- A trading account is set up
- After an injection of capital, a local broker can be designated

The gradual loosening of these controls resulted in the creation of multiple share classes which offer different privileges, depending on where the investor purchases the stock, where the listed company is incorporated, and the currency in which the stock is denominated.

Facilitating access through stock connect

For institutional investors, the big change occurred in November 2014 with the introduction of the Shanghai-Hong Kong Stock Connect scheme, followed in December 2016 by Shenzhen-Hong Kong Stock Connect. This unique collaboration offers international and Mainland Chinese investors the opportunity to trade securities in each other's markets through the trading and clearing facilities of their home exchange. Consequently, this allows international investors direct access to Chinese stocks. These market access schemes mark critical milestones in the opening up of China's equity markets and the internationalisation of the Renminbi.

Exhibit 22: Three main channels to access to Chinese onshore equity markets

CHINA ONSHORE EQUITIES					
	STOCK CONNECT	RQFII		QFII	
QUOTA SIZE	No quota limit	USD 218 bn		USD 150 bn	
ELIGIBLE INVESTOR	All investors	Only licensed investors based in selected eligible locations where the RQFII scheme is available		Only licensed investors that meet certain operation and AUM requirements	
QUOTA REQUIREMENT	No requirement	1 Quota linked to asset size or investment requirements. To be approved by SAFE; 2 Unused quota within a year will be cancelled		1 Quota linked to asset size or investment requirements.To be approved by SAFE 2 Unused quota within a year will be cancelled	
CAPITAL MOBILITY	1 No restriction 2 Daily investment quota of RMB 52 bn (USD 8 bn) for Northbound channel; RMB 42 billion (USD 6 bn) for Southbound channel	Open-Ended Funds: ▪ Repatriation: Daily ▪ Lock-up: None ▪ Remit Period: None ▪ Others: Quota required to be used within 1 year upon approval	Others: ▪ Repatriation: Daily ▪ Lock-up: 3 months ▪ Remit Period: 6 months	Open-Ended Funds: ▪ Repatriation: Daily ▪ Lock-up: 3 months ▪ Remit Period: N/A ▪ Others: Monthly repatriation cannot exceed 20% of NAV of previous year	Others: ▪ Repatriation: Daily ▪ Lock-up: 1 year ▪ Remit Period: 6 months ▪ Others: Monthly repatriation cannot exceed 20% of NAV of previous year
ELIGIBLE INVESTMENT	1480+ stocks listed on Shanghai & Shenzhen	All securities listed on Shanghai & Shenzhen Stock Exchanges			
CURRENCY	CNH (Offshore RMB)	CNH (Offshore RMB)		CNY (Onshore RMB)	

Source: BNPP AM, Bloomberg, as of March 2019.

QFII: Qualified Foreign Institutional Investor RQFII: RMB Qualified Foreign Institutional Investor.

The advantages for long-term investors are six-fold:

1. No need to apply for quotas (as opposed to QFII, RQFII)
2. No lockup or restriction on repatriation. Capital can be deployed quickly and access to the A-shares market has never been easier
3. Ability to use current broker to invest in overseas stocks, with costs comparable to those of investing in other countries
4. Possibility for existing QFII and RQFII investors to increase exposure and for new investors to gain greater exposure of portfolio to Shanghai / Shenzhen listed securities
5. New offshore Renminbi-denominated investment opportunities. Investors can trade Chinese stocks from Hong Kong and the funding is possible through CNH (offshore Renminbi) rather than CNY (onshore Renminbi)
6. Offshore investors protected by Hong Kong law when investing in PRC stocks through the HKEX.

Note that although there are some quotas in place that limit daily volumes within Stock Connect, the daily cap on the total quota is more than enough to accommodate most investors' needs. These programmes are not static – each has been refined and expanded since being launched. This is likely to continue as more participants join and as regulators streamline procedures andbroaden thescope of the schemes. This easier access has led to a significant increase in foreign investors' interest in the A-shares market.

In summary, offshore investors can access China A-shares in three ways:

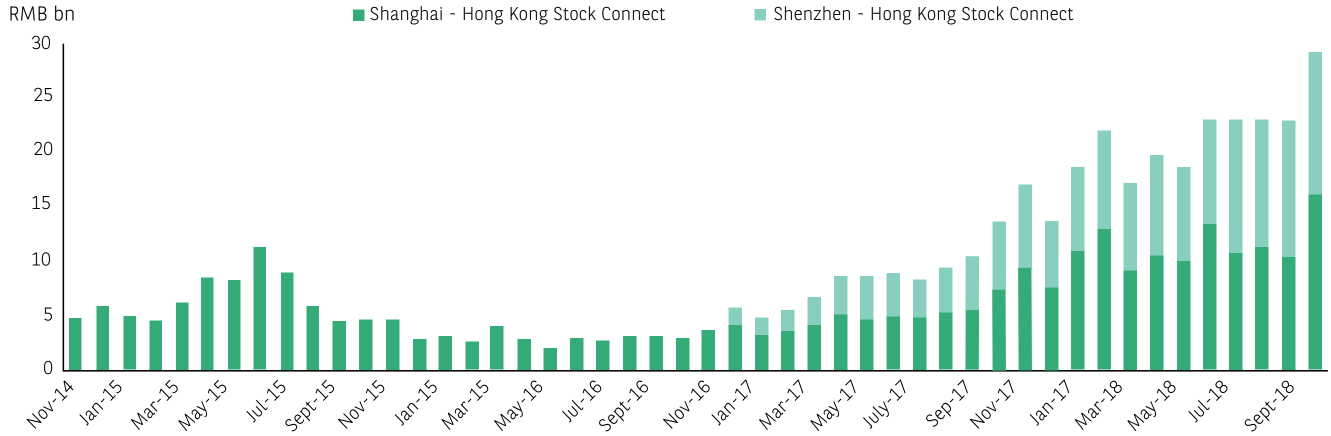
1. QFII (Qualified Foreign Institutional Investor)
2. RQFII (Renminbi Qualified Foreign Institutional Investor)
3. Stock Connect (Northbound)

Portfolio managers are starting to add more China exposure to their global portfolios (Exhibit 23). Global investors' participation is changing the structure of the A-shares market significantly, rendering it more mature and more fundamentals-driven, which favours the long-term growth of the A-shares market. As such, Stock Connect represents a key milestone in the globalisation of China's financial market.

Towards further liberalisation of Chinese economy and financial markets

Since the announcement of Stock Connect, the inclusion of the Renminbi in the IMF's Special Drawing Rights (SDR) basket and MSCI's inclusion of A-shares, China has continued to accelerate the opening up of its financial sector, announcing that it will ease limits on foreign ownership of banks and securities firms. In our view, this is a milestone event that sends the signal that China's authorities are confident that the country's financial institutions are now strong enough to compete directly with foreign rivals.

Exhibit 23: Flow to Chinese equities is gaining momentum
Northbound Stock Connects Average Daily Trading Volume



Source: BNP Paribas, HKEX, as of October 2018.

CHINA FIXED INCOME MARKETS

Quite simply, the scale of the Chinese bond market is vast! Standing at over USD 12 trillion at the end of 2018 (including both China onshore rates and credit bonds, as shown in Exhibit 24), it is the third largest bond market in the world, behind only the US and Japan.

Despite its size, however, this bond market only accounts for around 90% of the country's GDP while most developed countries bond markets are in excess of 200% of GDP. As China graduates towards developed market status and shifts towards a more consumption-driven economy, we would expect the Chinese bond market to continue to grow in size.

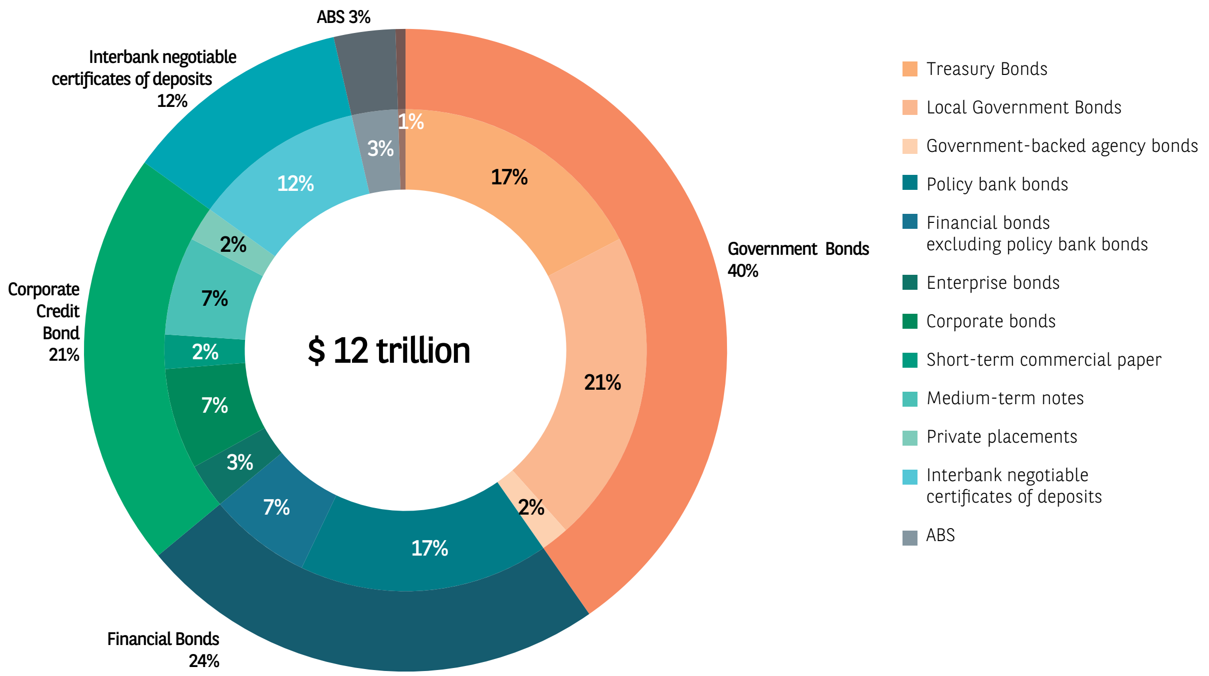
Despite its immense scale, it may be surprising to some that China's bond market is still one of the world's least owned by foreign investors, (Exhibit 25), reflecting years of restricted market access, capital controls, regulatory uncertainties, issues around transparency and relative illiquidity.

While these were all legitimate reasons to steer clear of this market in the past, we believe that we are now at an inflection point and that the Chinese bond market is becoming more accessible to foreign investors. Index inclusion should trigger sizeable inflows and there has been significant simplification of regulatory and policy layers. Additionally, further clarification on settlement and tax issues have alleviated investor concerns and, last but not least, macroeconomic and currency-related uncertainties have now meaningfully receded. We have already seen the initial effects of this evolution, with foreign net inflows into the onshore Chinese bond market increasing considerably over the past couple of years; however, we are still in the early stages of this global re-allocation of capital.

The regulatory journey so far

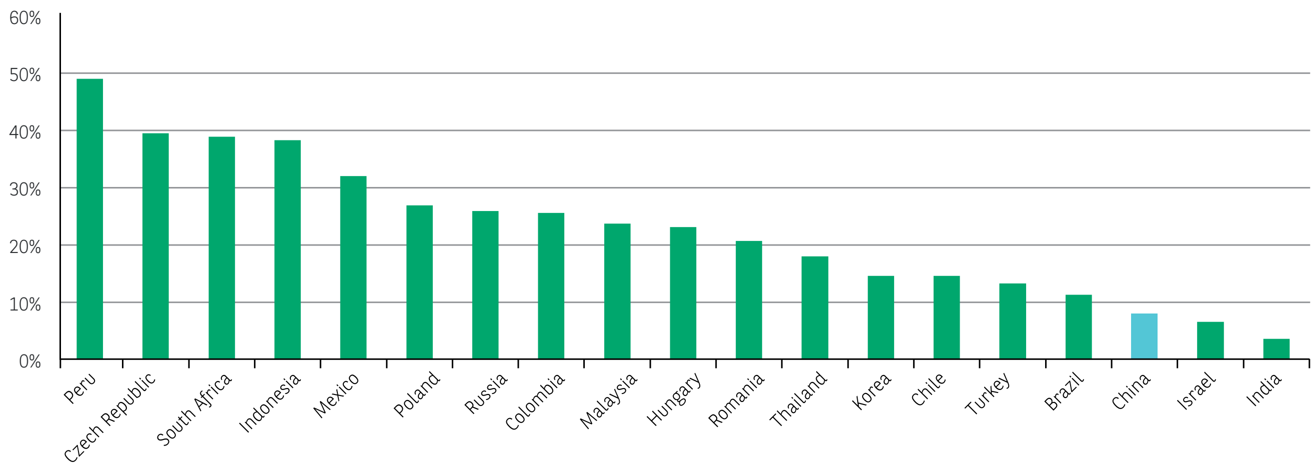
Despite its size and economic prowess, the onshore renminbi market was closed to foreign investors due to a number of regulatory hurdles. However, more recently, there have been significant moves by regulators as they prepare to internationalise the bond market and open it up to foreign investors.

Exhibit 24: Breakdown of the Chinese bond market



Source: Wind, Golden Credit, December 2018.

Exhibit 25: Figure 3: Foreign ownership (%) of local bonds outstanding



Source: JP Morgan, official sources, end of February 2019.

Exhibit 26: Evolution of the China fixed income regulatory moves

Oct. 2016	• Inclusion in the IMF Special Drawing Rights (SDR) basket at a weight of 10.92% • The next IMF review will take place by September 2021
Jul. 2017	• Launch of the Bond Connect programme for easier access to the onshore bond market by offshore investors • International credit rating agencies given access to rate onshore issuers
Nov. 2017	• PBoC issued detailed operational guidance for foreign investors' onshore RMB bond investments, including on account registration, settlements and tax rates • China announced further opening up of its capital account by reducing limits around foreign ownership in select finance businesses, as well as reducing tariffs on certain sectors
Aug. 2018	• China State Council announces 3-year tax waiver on China bond investments for foreigners • Bond Connect offers real time Delivery Versus Payment (DVP) settlement • Bond Connect launches block trading allocations, allowing asset managers to allocate block trades to multiple client accounts prior to undertaking trades
Apr. 2019	• Bloomberg includes onshore Chinese government and policy bank bonds in the Bloomberg Barclays Global Aggregate Bond Index, phased over 20 months
Jul. 2019	• China State Council, PBoC and multiple regulators jointly announce 11 measures to further open up access to China's financial markets, including by allowing foreign agencies to provide ratings on all onshore bonds, permitting foreign institutions to underwrite onshore bonds, relaxing QFII quotas and easing constraints around foreign investment and majority ownership in domestic financial institutions

Sources: BNPP AM, CSRC, PBoC, SAFE, as of 2019.

China has also overhauled its regulatory framework so as to have better centralised coordination and enforcement among the different regulatory bodies to make central policy initiatives more effective.

This has included:

- Merger of the banking regulator (CBRC) and the insurance regulator (CIRC) into a new body: CBIRC.
- Broadening of the PBoC's remit to include drafting key legislation for banking/insurance and for macro-prudential regulation.

Exhibit 27: Key regulators are now operating in the Chinese bond market space

People's Bank of China (PBoC)	Chinese central bank which controls monetary policy and regulates financial institutions in China. It has a dual mandate around monetary and financial stability.
China Central Depository and Clearing Corporation (CCDC)	Centralised depository and settlement for the interbank bond market
China Foreign Exchange Trade System (CFETS)	Supervises interbank lending, bond and FX markets (a subdivision of PBoC)
China Securities Regulatory Commission (CSRC)	Regulates China's securities markets and in charge of qualification approval of Qualified Foreign Institutional Investor (QFII) and (RMB or RQFII)
State-Owned Assets Supervision and Administration Commission (SASAC)	Performs investors' responsibilities, supervises and manages the assets of the state-owned enterprises under the supervision of Central Government
State Administration of Foreign Exchange (SAFE)	Regulates foreign exchange administration system and manages the country's foreign exchange market. Regulates foreign invested enterprise's RMB fund raising approval and their FX payments and guarantee.

Sources: BNPP AM, CSRC, PBoC, SAFE, as of 2019.

Accessing the Chinese onshore bond market

The scale and diversity of investment options available to the uninitiated could well feel overwhelming given the difficult of access in the past. It is indeed true that there have been many hurdles, with one of the most serious concerns being that of taxation uncertainty. However, we have now had clarification that foreigners will be exempted from paying taxes until end of 2021. The settlement process has been simplified and trading has been facilitated (Exhibit 28 shows the different routes to accessing the Chinese bond market).

There are now many options to access the market. The main differences between Bond Connect and China Interbank Bond Market (CIBM) are outlined in Exhibit 29. While the universe is basically the same for now and Bond Connect is sometimes seen as easier and quicker, we think that, in time, having genuine onshore access should allow investors access to a broader array of tools including onshore derivatives.

In our view, the political will to continue financial market reforms has been strengthened following the 19th National Congress of the Communist Party of China, at which President Xi Jinping was able to consolidate his power and influence.

Despite capital outflows having slowed in recent periods, Chinese policymakers' commitment to attract foreign capital remains strong. Even with high domestic savings rates, China's large augmented fiscal deficit of c. 8%-9% of GDP (including quasi-sovereign entities and sub-levels of the government) will require significant portfolio inflows to help finance and rebalance the economy. China has traditionally been very slow and cautious in opening up its capital account. However, this time around, we expect its commitment to be strong and irreversible.

Exhibit 28: Four different routes to access onshore Chinese bonds

Investment Scheme	CIBM Direct	Bond Connect	QFII Qualified Foreign Institutional Investor	RQFII RMB Qualified Foreign Institutional Investor
Eligible Investor	• Overseas Central Banks, Supranational, Sovereign Wealth Fund (FOIs) • Asset Managers, Funds, Insurance companies, Securities companies, Commercial bank	• Overseas Central Banks, Supranational, Sovereign Wealth Fund • Asset Managers, Funds, Insurance companies, Securities companies, Commercial bank	• Asset Managers, Funds, Insurance companies, Securities companies, Commercial banks, others (pension funds, government institu-tions...)	• Financial institutions with principal place in approved RQFII jurisdictions with an asset management licence
Eligible Invest-ment Scope	• CIBM • Bonds • Bond lending, Bond forward, interest rate derivatives • FX derivatives • Repo	• CIBM • Bonds • FX derivatives Note: Future investment scope will expand to bond repurchase, bond lending, bond forward and interest rate derivatives	• Fixed income products listed and traded in • CIBM, and • Exchange markets	
Quota	• No quota limitation	• No quota limitation	• Base quota mechanism • SAFE registration/approval for quota	
Access	• Register with PBoC through a Type A Interbank Bond Settlement Bank • FOIs can access directly or entrust PBoC / Type A bank as agent	• Register with Bond Connect Company Ltd. • Rely on existing Global custodian who appoints a CMU member in Hong Kong to be the offshore custodian	• For CIBM Investment: Entrust a Type A Interbank Bond Settlement Bank • For exchange market investment: Entrust onshore custody for cash settlement, and onshore brokerage	

CMU: Central Moneymarkets. Unit Sources: BNP Paribas, CSRC, PBoC, SAFE.

Exhibit 29: Bond Connect vs. CIBM Direct

	Bond Connect (Northbound)	CIBM Direct
Set-up process	• Simpler application process and shorter expected turn-around	• Longer set-up process
Eligibility	• Same as CIBM Direct Access	• Financial institutions; medium to long-term investors
Product scope	• Cash bond and FX derivatives for hedging purposes • No access to onshore repo • FX spot conversion and hedging; FX hedging pending more control/ monitoring details – via the appointed HK Settlement Bank	• Cash Bond, interest rate and FX derivatives for hedging purpose • Onshore repo for commercial banks • FX spot conversion and hedging - via the appointed BSA
Registration	• Registration with PBoC through BCCL • Registration could be at company or product level	• Registration with PBoC through settlement agent bank • Registration needs to be at product level for fund managers
Trading Platform	• International trading platforms Tradeweb and Bloomberg • Additional cost charged for connectivity (1bp on notional) • Unable to negotiate prices on electronic platform	• OTC trading with agent bank who trades on investors' behalf on CFETS or RFQ basis • Able to negotiate prices with counterparties
Quota	• No quota is imposed or needs to be indicated	• No quota is imposed, but investment is subject to registered amount indicated by investors
Settlement/custody	• Rely on existing Global Custodian which has already appointed a local custodian in HK (acting as HK CMU member) • Investor has no contractual relationship with onshore settlement agent. Back to a normal custody and legal framework: (Investor/Global Custodian/Sub Custodian) • Account structure in CMU (segregated at investor level). Account structure in CCDC and SHCH: One omnibus CMU account opened as nominee • Settlement cycle same as CIBM Direct Access	• DVP settlement for CCDC & SHCH • Need to open accounts directly with Settlement agency, CCDC and SHCH. • Settlement cycle : T+0, T+1 and T+2 settlement
Ownership structure	• Nominee structure held via CMU	• Bond held onshore by investor directly
Restrictions	• Same as CIBM Direct Access	• No lock-up period or repatriation restrictions
Tax	• Tax rates clarified • How and when to be collected remain unclear • No capital gain tax • Coupon tax: Waived for Govi and municipal bonds and , 16% on rest of the bonds; • Coupon interest income received by overseas institutional investors in China bond market will temporarily be exempted from corporate income tax (CIT) and value added tax (VAT) for three years.	• Tax rates clarified • How and when to be collected remain unclear • No capital gain tax • Coupon tax: Waived for Govi and municipal bonds, 16% on rest of the bonds; • Coupon interest income received by overseas institutional investors in China bond market will temporarily be exempted from corporate income tax (CIT) and value added tax (VAT) for three years.

Source: PBoC, BNPP AM, PwC China. Invesco, as of 2019. BCCL: Bond Connect Company Limited; BSA: Bond Settlement Agent; RFQ: Request for Quotation; SHCH: Shanghai Clearing House.

CHINA'S INCLUSION WITHIN INDICES AND ITS IMPLICATIONS

CHINA A-SHARES INCLUSION IN THE MSCI INDICES

The weight of China A-shares in the MSCI global indices will quadruple in 2019, creating a sizeable investment opportunity for foreign investors in the long term. With the inclusion factor rising to 20%, the index weight of A-shares will reach 3.3% in the MSCI Emerging Markets index. The greater weight will enable foreign investors to play a bigger part in the A-shares market and comes amid further reforms and steps to open up the capital market.

MSCI is expected to quadruple China A-shares' weight in global indices

Global index provider MSCI will raise the inclusion factor from 5% to 20% in three steps. These steps suggest that the pro-forma index weight of A-shares in the MSCI Emerging Market index (MSCI EM) will rise to 3.3% by November 2019 from the current 0.7%. At the sector level, consumer staples, industrials and materials will have a higher weight in the MSCI China index, mostly offset by a reduction in the weight of technology and communication services.

Improved market access accelerated MSCI inclusion

The latest MSCI decision followed overwhelming support from international institutional investors. Investors recently welcomed the following commitments by the Chinese authorities:

- **Facilitate the smooth running of Stock Connect** – quadrupling of the Stock Connect daily limit to RMB 52 billion (USD 8 billion) for northbound and RMB 42 billion (USD 6 billion) for southbound trade in May 2018.
- **Accelerate China's QFII / RQFII reform** – the regulator doubled the total quota for QFII from USD 150 billion to USD 300 billion in January.
- **Improve market accessibility** – trading suspensions fell to fewer than 20 in December 2018, compared to over 150 in December 2017.

A further increase in the weight of A-shares beyond 20% would largely depend on the Chinese authorities addressing the remaining market accessibility problems (e.g. access to hedging and derivatives, the short settlement cycle of China A-shares or trading holidays on Stock Connect).

Exhibit 30: Estimated weighting of A-shares in MSCI indices post-implementation

INDEX	A-SHARE WEIGHTING AT 5% IF	A-SHARE WEIGHTING AT 20% IF	A-SHARE WEIGHTING AT 100% IF
MSCI Emerging Markets	0.7%	3.3%	14.2%
MSCI AC World	0.1%	0.4%	2.0%
MSCI AC Asia ex-Japan	0.8%	4.0%	16.1%
MSCI China	2.3%	10.4%	34.1%
INDEX	**MSCI CHINA WEIGHTING AT 5% IF**	**MSCI CHINA WEIGHTING AT 20% IF**	**MSCI CHINA WEIGHTING AT 100% IF**
MSCI Emerging Markets	30.9%	31.9%	41.7%
MSCI AC World	3.7%	4.0%	n/a
MSCI AC Asia ex-Japan	44.5%	38.0%	47.3%

Source: MSCI, BNPP AM, data as of 1 March 2019. IF: inclusion factor. Data at full inclusion are estimates.

From a longer-term perspective, improved foreign investor access should pave the way for the A-shares weight to rise further. In the case of full inclusion, A-shares (together with China offshore) should take the weight of Chinese equities to about 40% of the index (Exhibit 30). A move towards full inclusion would be a lengthy and gradual process. It took about nine years for Taiwan and six years for South Korea to move from initial partial inclusion to full inclusion.

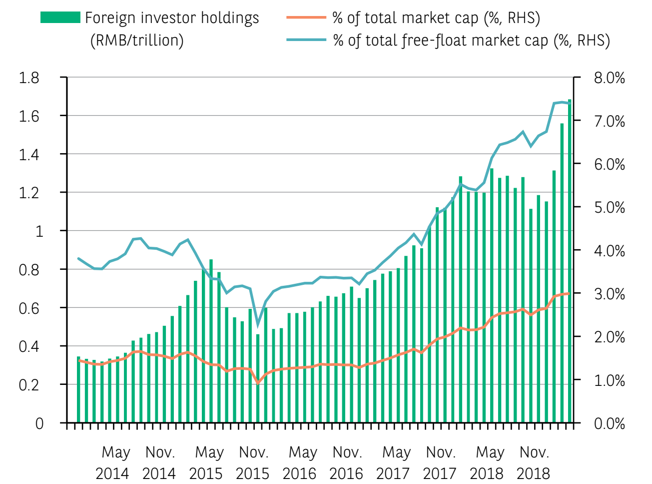
In our view, the latest news concerns more than just a further opening by MSCI – wider inclusion in the indices is a sign of international recognition of China's market liberalisation efforts.

Foreign investors now play a significant role in the A-share market

The expanding share of China A-shares in MSCI global indices should help strengthen global interest in this market and trigger more foreign fund inflows into China. Rising foreign participation should favour the increasing institutionalisation of the market. We believe this would be desirable given that the A-shares market is still mostly retail-driven.

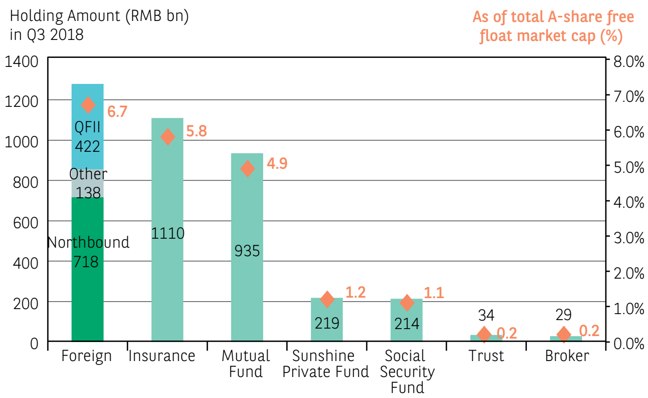
We expect the MSCI inclusion of A-shares to attract USD 400 billion of inflows over the next five to 10 years. According to the PBoC, foreign investors held RMB 1.15 trillion (USD 171 billion) of A-shares as of December 2018. They accounted for 6.7% of the free-float market cap of the onshore market, up from 2.3% in November 2015. In terms of total market cap, they accounted for 2.6% of the onshore market, an increase from 0.9% in November 2015 (Exhibit 31).

Exhibit 31: Foreign investors' A-shares holding is accelerating



Source: UBS, PBoC, Wind, as of 1 March 2019.

Exhibit 32: Foreign investors as a whole are now the largest institutional players in the A-shares market



Source: Wind, PBoC, HSBC, as of 1 March 2019.

CHINA BONDS INCLUSION IN THE INDICES

Despite China's significant size, economic prowess and high credit rating (A+ by S&P), the onshore renminbi market has, until now, been excluded from the mainstream emerging and developed market bond indices due to a failure to meet certain index inclusion criteria as prescribed by the index providers. That is all changing now, though, and China is currently under consideration for inclusion by the major bond index providers as it meets most of the essential criteria required for inclusion (for example, no capital controls, currency convertibility, ability to hedge exposure).

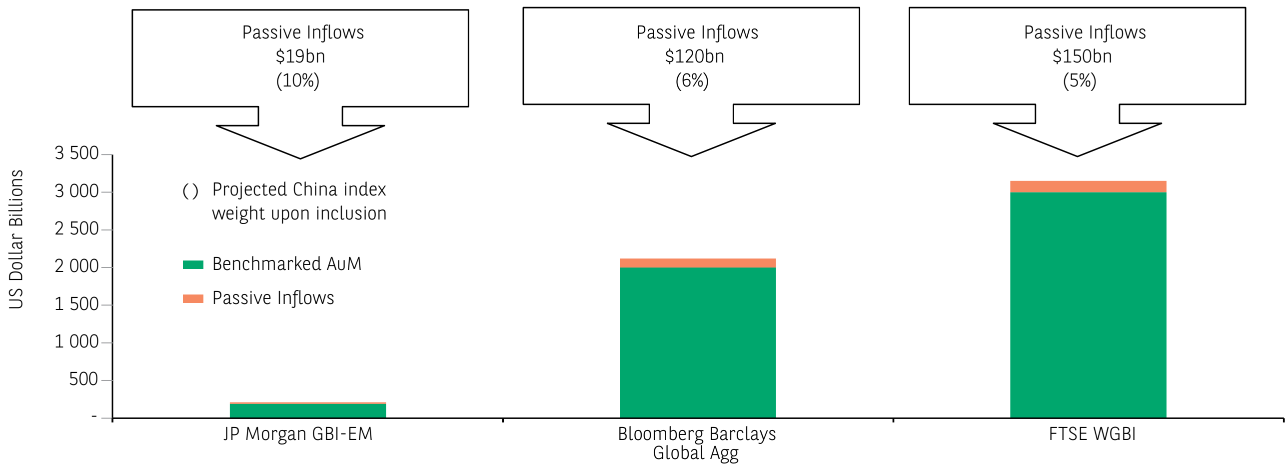
Index inclusion is a game changer. The final weight of China in the Bloomberg Global Aggregate index will be more than 6% (the inclusion will be gradual and will continue until November 2020). Current rules for index inclusion are quite strict: bonds have to pay a fixed coupon, have an outstanding amount of at least RMB 5 billion and a remaining tenor of one year or longer.

Over time, Bloomberg could consider including local government bonds, corporate bonds and asset-backed securities in the Bloomberg Global Aggregate index, which could trigger additional inflows and a higher weight for China.

Based on our estimate, passive inflows linked to this inclusion could amount to c. USD 120 billion over the next couple of quarters. In addition to this, the likely inclusion in JP Morgan GBI EM Global Diversified could trigger roughly USD 20 billion and potential inclusion into FTSE WGBI another c. 150 billion (Exhibit 33). Total passive inflows could amount to some USD 250-300 billion.

However, these figures only related to passive index inclusion inflows. They do not include other potential flows, for example via global central banks increasing foreign reserves in the renminbi. In addition, should this market eventually catch up with the levels of foreign ownership seen in mature markets or even in smaller emerging markets, this would translate into several USD trillions of inflows in the years to come.

Exhibit 33: Expected passive inflows from index inclusion

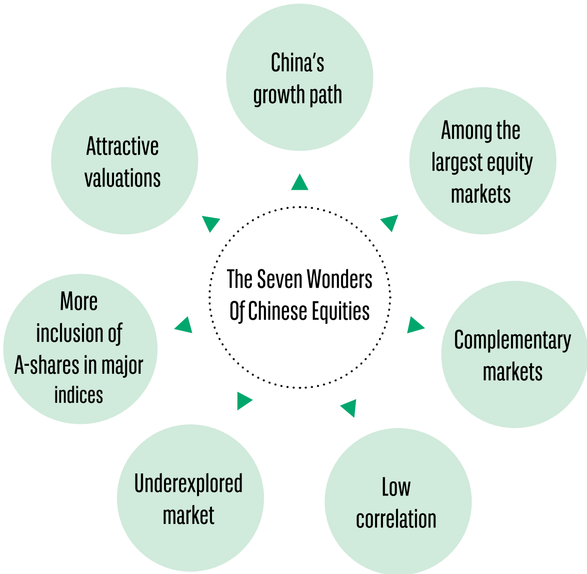


Source: BNPP AM, JP Morgan, Bloomberg, FTSE Russell, February 2019.

HOW "ALL-CHINA" EQUITIES CAN ENHANCE A GLOBAL EQUITY PORTFOLIO FOR ACTIVE INVESTORS

As the China onshore equity market opens up to foreign investors and the MSCI inclusion of A-shares accelerates, large amounts of capital are expected to flow into the Chinese equity markets over the long term.

In addition to a tactical investment in China A-shares, we believe there are strong strategic reasons for regarding it as a long-term investment proposition:



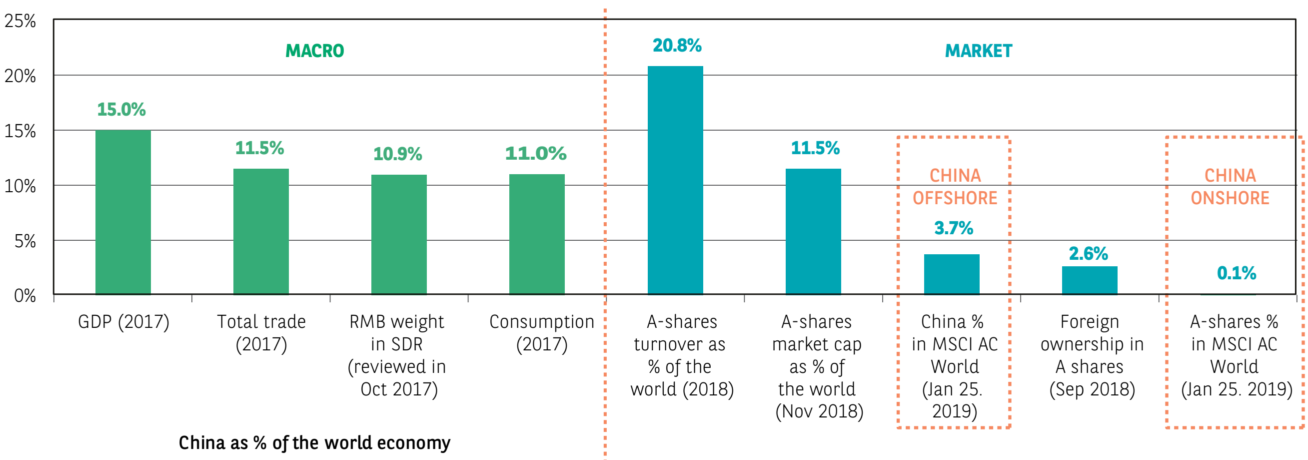
REASON #1: UNTAPPED OPPORTUNITY IN CHINA'S GROWTH PATH

There is every prospect of China continuing its impressive growth path with powerful domestic tailwinds, such as urbanisation and a growing middle class, and much scope for the country to boost its per capita GDP and productivity.

China's GDP growth was 6.6% in 2018. Although China's economic engine is cooling down, it continues to rack up one of the world's fastest rates of economic growth."The International Monetary Fund predicts that if current trends continue, China would overtake the US as the world's largest economy (in nominal USD terms) by 2030", according to Chi Lo, BNPP AM's senior economist dedicated to China. In recent years, "China's growth has contributed about a third of global growth and its contribution is expected to rise to 35% in 2019 and 2020, according to the UN[15]".

The major change from the past is that the Chinese government is focused more on high quality, stable growth rather than on achieving the fastest growth possible. Despite its economic contribution in a global context, Chinese equities appear to be under-represented in global indices (Exhibit 34).

Exhibit 34: Chinese equity markets have lagged behind the spectacular growth of the economy



Source: FactSet, MSCI, BNPP AM, Goldman Sachs Global Investment Research, as of 8 February 2019.

15. According to the "World Economic Situation and Prospects 2018" released by the United Nations in January 2019.

REASON #2: CHINA A-SHARES: ONE OF THE WORLD'S LARGEST EQUITY MARKETS

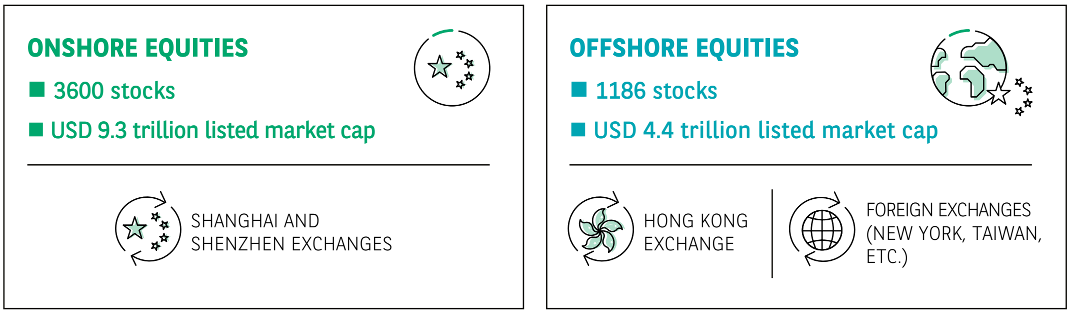
China's equity market has been growing at a dramatic pace since its opening in 1990, both in terms of market capitalisation and breadth of listed companies.

Today, the Shanghai and Shenzhen Stock Exchanges constitute one of the largest equity markets, with total market capitalisation of about USD 9.3 trillion and more than 3 600 stocks (as of 31 March 2019). The market capitalisation of the markets is only surpassed by the Nasdaq (USD 11 trillion) and the New York Stock Exchange (USD 25 trillion).

The total market capitalisation of Greater China equity markets (Shanghai, Shenzhen and Hong Kong Stock Exchange) is approximately USD 12 trillion (Exhibit 35).

A large market tends to imply a level of maturity, which is not yet the case with China A-shares. The market remains dominated by retail investors, who typically have a short-term approach and are momentum-driven. Retail investors account for about 86% of the total trading volume in the China A-share market (vs. 35% in Hong Kong).

Exhibit 35: Chinese equity markets are large, liquid and among the most active exchanges in the world



Source: Wind, FactSet, UBS, as of 31 March 2019.

REASON #3: COMPLEMENTARY MARKETS, WITH A NUMBER OF UNIQUE OPPORTUNITIES IN LOCAL MARKETS

In addition to the size of the opportunity set, China A-shares provide more diversified access to structural growth opportunities – a complement to the current offshore China exposure.

The reasons are three-fold:

1. China's onshore and offshore equity markets are complementary.
2. The dual listings (stocks listed both as A-shares trading in Shanghai and H-shares trading in Hong Kong) provide trading and financing opportunities.
3. There is a significant difference in sector weights between the different types of shares.

Hong Kong-listed companies historically have been dominated by large state-owned enterprises in the financial and energy sectors.

In constrast, one attractive attribute of A-shares is their higher exposure to non-government-owned companies in consumption-driven industries. The Shenzhen exchange, in particular, has a more attractive selection of companies, with about 62% of Shenzhen's market capitalisation in technology, consumer goods and industrials.

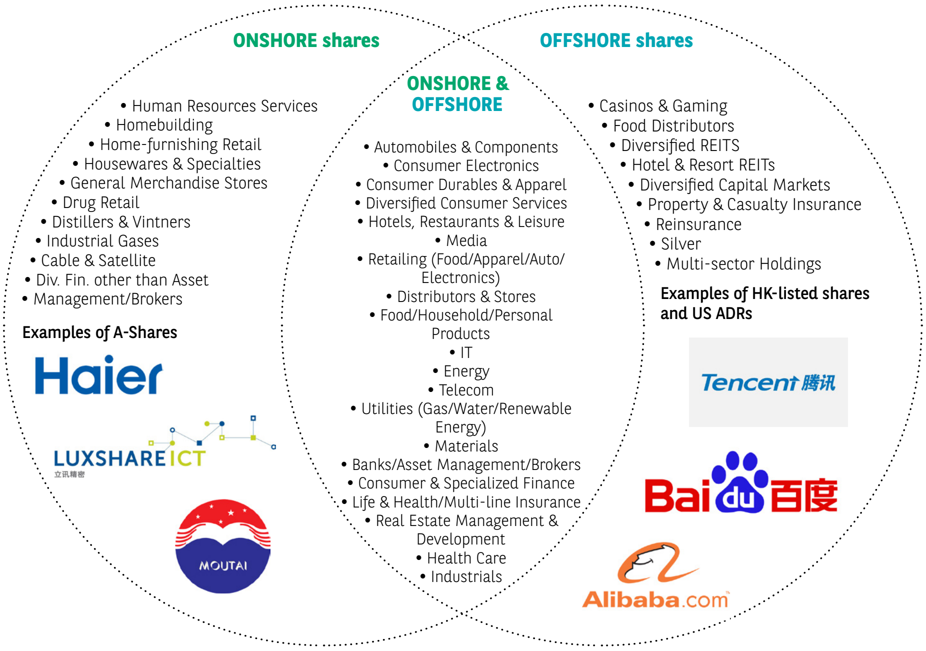
Most importantly, a number of these sectors can be unique to A-shares, such as Chinese spirit brands or pharmaceutical companies providing diabetes treatments for the ageing population (Exhibit 36).

By investing in both China's onshore and offshore shares, investors can benefit from:

1. Risk management via sector diversification

2. Broadened opportunity set for alpha generation

Exhibit 36: Chinese onshore and offshore universes are complementary[16]



Source: Wind, FactSet, Goldman Sachs Global Investment Research, as of June 2019.

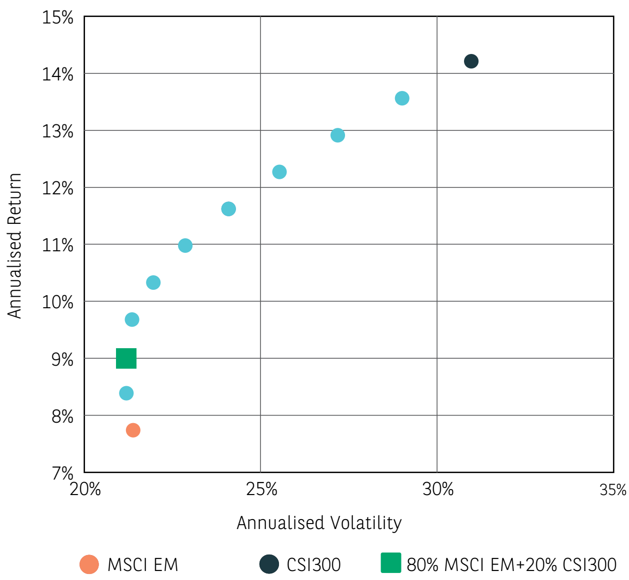
REASON #4: LOW CORRELATION PROVIDES DIVERSIFICATION

China A-shares have some features that make them different from typical China exposure in a global portfolio.

- More than 90% of the revenue of China A-share companies is domestically driven, and thus relatively less sensitive to global macroeconomic trends. For decades, the onshore market developed in isolation, with few foreign investors following A-shares, so the A-shares market tends not to transmit global shocks with the same intensity as markets elsewhere.
- In addition to a domestic retail investors-focused market, these various elements resulted in a low correlation between China A-shares and other global equities, as indicated by the historical correlation of approximately 0.4 between China A-shares and the MSCI World index.
- This low correlation and ample liquidity mean A-shares can provide an effective means for foreign investors to diversify their portfolio.

While exposure to Chinese equity can appear challenging from a risk-return perspective, the diversification in the portfolio mitigates this to some extent, such that risk-adjusted returns may actually improve. As a result, adding China A-shares can potentially enhance the risk-return profile for an emerging market (EM) portfolio (Exhibit 37), as well as a China offshore equity portfolio.

Exhibit 37: Adding China A-shares can potentially enhance the risk/return profile of an emerging market equity portfolio as well as a China offshore equity portfolio
(15-year period, as of 24 May 2019)



Source: BNPP AM, as of 24 May 2019.

16. The above-mentioned securities are for illustrative purpose only, are not intended as solicitation of the purchase of such securities, and does not constitute any investment advice or recommendation. Trademark, copyright, and other intellectual property rights are and remain the property of their respective owners.

REASON #5: UNDEREXPLORED MARKET, OFFERING MISPRICING OPPORTUNITIES

Chinese equities markets, particularly the A-shares market, remain highly inefficient and potentially offer skilled investors significant scope to add value.

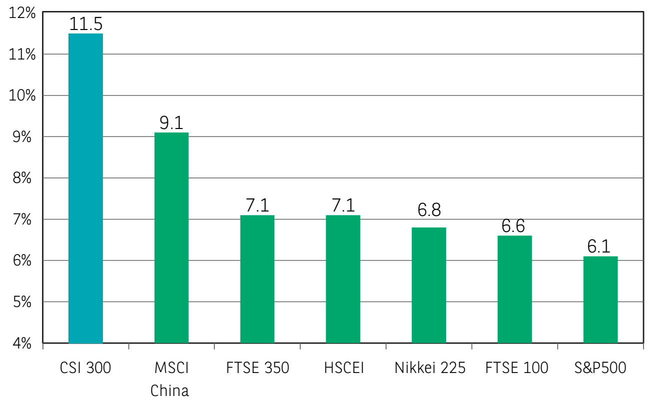
Local retail investors account for more than one-third of the free float and some 86% of transactions. Retail investors in China tend to be on the lookout for rapid capital gains, which explains the popularity in recent years of smaller high-growth companies.

China A-shares are thus prone to contribute to higher volatility driven by investor speculation and sustained by momentum trading (vs. the US and Hong Kong). The China A-shares market is much more volatile, with the average standard deviation of monthly returns around 11.5% (vs. 7% for Hong Kong).

The dispersion of returns in A-shares is also significantly higher compared to those from global markets, which presents a great opportunity for skilled fundamental stock pickers (Exhibit 38).

Exhibit 38: Higher dispersion of returns in China A-shares vs. developed markets

Average standard deviation of constituents' monthly returns over the last 5-years (average)



Source: Thomson Datastream, UBS, as of 14 May 2018.

Most importantly, there is currently a lack of coverage of Chinese stocks by sell-side analysts and the quality of domestic broker coverage in A-shares tends to be relatively weak. Only 7% of onshore stocks are audited by the 'Big 4' global auditing firms, with 57% audited by local tier-1 firms.

A focus on corporate governance risks is also critical when investing in emerging markets, and this is especially true for A-shares. It is encouraging to note that the number of stock suspensions has gone down significantly, from 1 422 suspended stocks in July 2015 to just 14 in January 2019.

Active managers who have the resources to undertake their own on-the-ground research in China, and who have a long-term investment horizon to benefit from the lower market efficiency, should be well placed to take advantage of the investment opportunity in China A-shares.

REASON #6: FURTHER A-SHARES INCLUSION IN MSCI, FTSE AND S&P INDICES

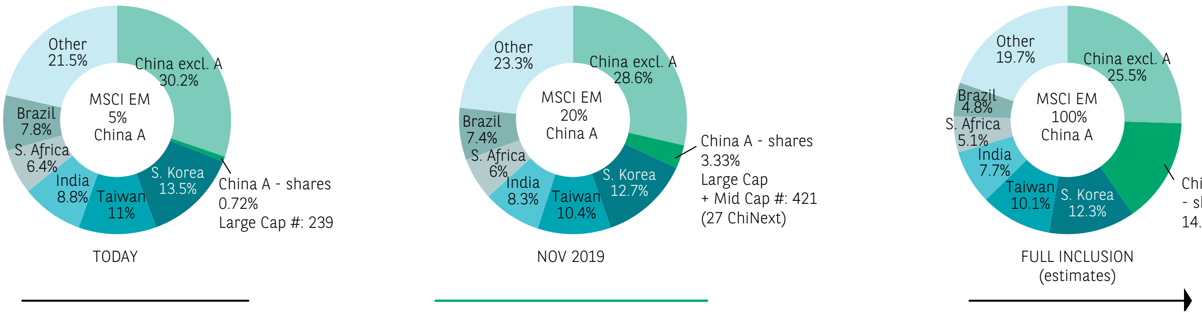
MSCI is quadrupling the weighting of domestically traded Chinese stocks in its emerging market indices, starting from May 2019.

In a three-step plan, the share of large-cap China A-shares will increase from a 5% inclusion factor (June 2018) to a 20% inclusion factor (November 2019), as exemplified in Exhibit 39.

The decision of the key global index providers (MSCI, FTSE, S&P) to include some more China onshore companies in their indices was a significant milestone in the mainstream acceptance of Chinese equities in international investors' portfolios.

In our view, this inclusion helps support the Renminbi and improve the China A-shares market's investor structure from being retail-focused to a more balanced mix of institutional and retail investors. We believe that the inclusion will likely improve China's capital market liberalisation as well as regulations.

Exhibit 39: Pro-forma weight increase in the MSCI EM index in three steps



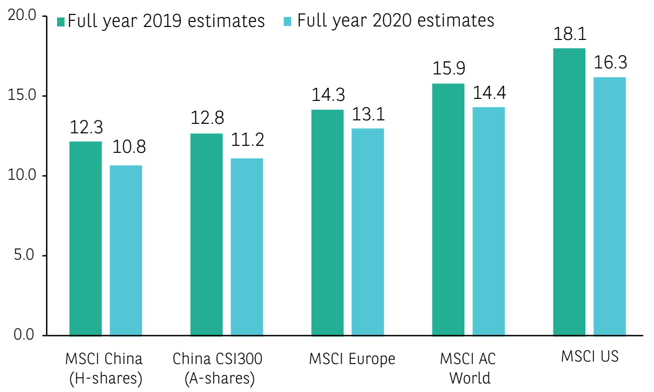
Source: BNPP AM, MSCI, data as of April 2019.

REASON #7: ATTRACTIVE VALUATIONS

Both China A- and H-shares markets are reasonably priced relative to those of developed equity markets and to their historical average.

The MSCI China (offshore) and CSI 300 (onshore) indices are attractively valued at around 12.3x P/E and 12.8x for the 12-month forward P/E, respectively, thus representing a discount compared with MSCI US, MSCI Europe and MSCI World indices, as of 30 June 2019 (Exhibit 40).

Exhibit 40: China equity valuations look moderate vs. developed markets



Source: BNPP AM, Bloomberg, as of 30 June 2019.

Not only does the Chinese equity market benefit from attractive valuations against developed markets, but it also enjoys strong Earnings Per Share (EPS) growth. The MSCI China and CSI 300 indices benefit from consensus EPS growth of 12% and 14% in 2020 estimates (as of 30 June 2019).

CONCLUSION

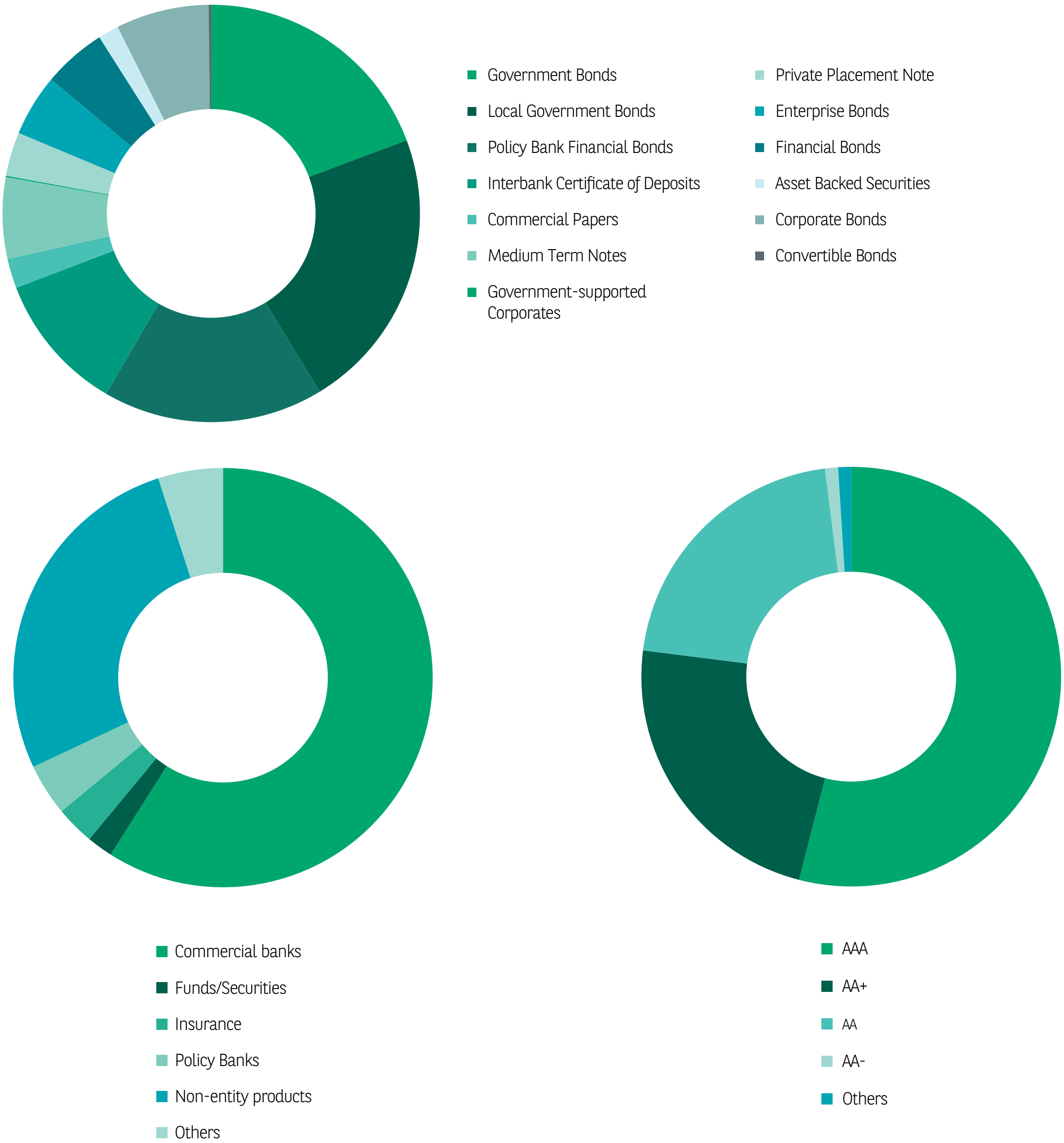
CHINA A-SHARES ARE BECOMING INCREASINGLY IMPORTANT FOR GLOBAL INVESTORS

It is essential to closely monitor the market given its higher volatility (vs. developed markets), and changes in factors such as valuations and earnings may require tactical portfolio adjustments. Although risks when investing in China should not be overlooked, we believe that the opportunities for growth for Chinese companies are broad-based and positive. We believe that Chinese equity markets may present a number of attractive opportunities given the long-term structural trends.

HOW CHINA ONSHORE FIXED INCOME MARKETS CAN BECOME A DOMINANT SOURCE OF ALPHA FOR ACTIVE INVESTORS

Not only is it huge, but the onshore Chinese fixed income market is also relatively diverse. For those able to navigate it successfully, the market offers investors access to a wide range of instruments. However, the diversity in credit profiles is sometimes hidden by the still early-stage methodology for onshore rating (two-third of the onshore market is rated AAA even though part of this universe carries significant credit risk) and is still predominantly owned by commercial banks (Exhibit 41). The picture is changing, however, as ownership by pension funds, insurance companies and asset management companies has recently grown.

Exhibit 41: Renminbi onshore bonds trading



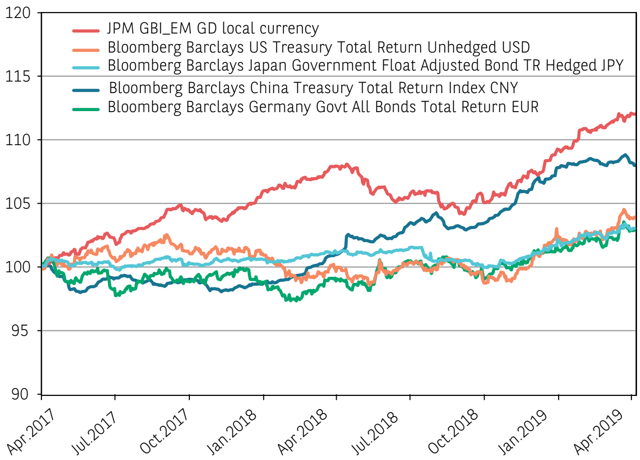
Source: JP Morgan, official sources, end of February 2019.

Overall, we see the long-term outlook for rates and policy banks as positive. Although we do expect some rising supply at the sub-sovereign level (especially at the provincial level), the combination of contained inflation off the back of only moderate fiscal and monetary stimulus and incremental foreign demand should help keep yields low. In the shorter term however, we do expect some volatility as many local investors are likely to shift from money market or conservative fixed income funds to more aggressive equity funds so the domestic demand side could weaken slightly.

On top of index inclusion as we discussed previously, we think we are only at the beginning of the allocation of central banks' reserves into the onshore Chinese market. The weight of China has recently been increasing and is now approaching 2%, roughly in line with allocations to the Australian and Canadian dollars. Over time, we think the weight of renminbi-denominated assets (CGBs and policy banks) could well be in excess of 5%.

This fundamental mispricing of the onshore market has to do with the demand structure. For onshore investors, Chinese rates (including policy banks bonds) are "risk off", i.e. they represent a risk-free rate. The correlation is usually negative with the A-shares equity market. However, from a foreigner's perspective, adding the China rates risk is seen as "risk on", with a low correlation with other types of global emerging market local currency debt instruments. This divergence in views naturally creates some mispricing and offers an opportunity for alpha generation. Given these atypical features, the Chinese bond market usually displays a relatively low correlation with both developed markets' rates and emerging market local currency debt, as well as relative stable returns (Exhibit 42 and 43). The risk/reward profile is quite distinct from that of other emerging market instruments.

Exhibit 42: Performance of CGBs vs. EM and DM



Source: BNPP AM, Bloomberg, April 2019. DM: Developed Markets.

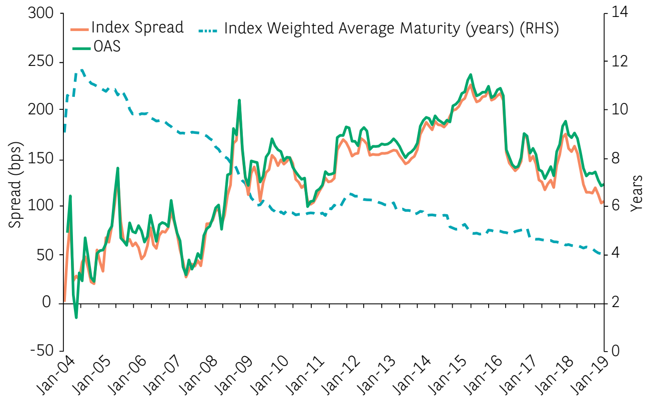
Exhibit 43: Correlation over two years of CGBs vs. EM and DM

	CGB	GBI EM	DBR	UST	JGB
CGB	1.00	0.34	-0.05	-0.02	0.33
GBI EM		1.00	-0.22	0.11	0.34
DBR			1.00	0.74	0.62
UST				1.00	0.61
JGB					1.00

Source: BNPP AM, Bloomberg, monthly returns over two years to April 2019. CGB: China Government Bond; GBI EM: JP Morgan Global Bond Index Emerging Markets; DBR: German government bonds; UST: US Treasury; JGB: Japan Government Bond.

On the other side of the spectrum, onshore credit spreads always had the tendency to be tight in China (Exhibit 44), the main reason being that there was no price discovery mechanism. Credit risk traditionally tended to be priced from a top down perspective (i.e. trying to assess the level of government support) rather than attempting to price standalone credit risk.

Exhibit 44: Bloomberg Barclays China Corporate Total Return Index Unhedged USD and Index Spread



Source: BNPP AM, Bloomberg, April 2019. OAS: Option adjusted spread.

We think we are now at a major inflection point: policymakers are willing to inject more credit risk into the system. In the short term, onshore credit spreads are likely to widen as the credit ratings are reassessed and brought more in line with other global issuers. Until now, Chinese domestic rating agencies have been far too complacent and many AAA rated Chinese corporates actually carried significant credit risk.

However, the gradual opening to foreign rating agencies seems to be encouraging. We would expect higher corporate spreads in the short term and a rise in onshore corporate defaults. This might be painful in the short term but should be seen as a healthy longer-term development.

WHERE ARE THE RISKS?

There are a number of risk factors related to investing in Chinese equities and fixed income markets, specifically onshore markets, that investors should not overlook.

Some of the key risks include:

Growth slowdown: China has faced significant growth in debt levels since the financial crisis, but the government has started to address this. Despite its manageable debt levels, China's debt reduction and state-reform programmes are directly addressing debt burden issues within the financial system, and while this is very positive long term, we should expect onshore credit default rates to rise from historical low levels as over-indebted and less systemically important companies are allowed to default. We also expect policymakers to continue to resort to counter-cyclical targeted stimulus and liquidity programmes to stablise growth and avoid systemic risks during periods of heightened uncertainty.

Regulatory & transparency-related risks: Listed companies have the option of suspending trading of their own shares and such suspensions can last for months at a time. During the height of the large market sell-off of mid-2015 and 2016, investors felt the impact of regulatory risks when the Chinese government stepped in in the A-shares market to temper rapid security price increases. This was an unprecedented move amid efforts to avert a market meltdown. Stock suspensions helped stop a share rout from turning into a systematic risk. Concerns around investment quotas and capital controls have also been prevalent in the past. However, as policymakers seek to attract more foreign investor participation, they are making efforts to address these concerns. They are aiming to create a unified regulatory framework to enable the more efficient allocation and acces¬sibility of capital. In addition, transparency related concerns are also being actively addressed, most recently via enabling international rating agencies to rate onshore companies.

Currency risk: The heavy management of the renminbi gives stability and helps dampen volatility. But many economists believe that it is impossible to combine: 1) a fixed and stable exchange rate, 2) independent monetary policy, and 3) free international capital flows. If China has to give up one element of this so-called 'impossible trinity', currency control could be the one. Indeed, we have seen greater exchange rate flexibility employed by Chinese policymakers in recent years and should continue to expect further FX liberalisation over time as Chinese capital markets open up to international investors.

Liquidity risks: Given the sticky domestic client base, particularly in the higher quality onshore bond market, trading in size or in the secondary markets can present challenges. Over time, a more diverse investor base, including foreign investors with different risk and return objectives should enhance liquidity conditions. China's equity market has been growing at a dramatic pace both in terms of market capitalisation and breadth of listed companies since 1991, making it one of the most liquid equity markets in the world. However, stock suspensions prevent the normal functioning of the market and cause illiquidity. Starting in November 2018, the China Securities Regulatory Commnission announced a series of guiding principles – companies are required to improve communication and transparency, and avoid long-term trading suspensions. The new guidelines limit the circumstances under which a company can apply for suspension.

ABOUT BNP PARIBAS ASSET MANAGEMENT ASIA LIMITED

BNP Paribas Asset Management (BNPP AM) is the investment management arm of BNP Paribas, one of the world's major financial institutions. Managing and advising EUR 575 billion (USD 639 billion) in assets as of 30 June 2019, BNPP AM offers a comprehensive range of active, passive and quantitative investment solutions covering a broad spectrum of asset classes and regions. With more than 520[17] investment professionals and around 500[17] client servicing specialists, BNPP AM serves individual, corporate and institutional investors in 71[17] countries around the world. Since 2002, BNPP AM has been a major player in sustainable and responsible investing. BNPP AM Asia Limited was established in 1992 and offers investment management services to both institutional and retail clients.

Although retaining full investment and portfolio management discretion for onshore Chinese strategies, both our 'Greater China Equities' and 'Emerging Markets Fixed Income' investment teams can draw on the vast resources of BNPP AM. With over 40 investment professionals on the ground contributing to stock ideas, the two investment teams draw on the support of local and global teams, including:

- **Our Senior Economist dedicated to Greater China:** Chi Lo complements our macroeconomic view for risk mitigation.

- **Our Sustainability Centre:** four members of the 25-strong global Sustainability Centre are based in Hong Kong, supporting the investment team for ESG integration and engagement.

- **Our joint venture HFT Investment Management:** over 40 investment members bring additional onshore equities and fixed income research. This joint venture between BNPP AM and Haitong Securities Co. Ltd was formed in 2003 and was one of the first of its kind to be approved by the Chinese government.

The Greater China Equities team is based 'on the ground' in Hong Kong and Shanghai, and manages or advises on assets in excess of USD 1.0 billion (as of 30 June 2019), for both local and international investors.

This award-winning investment team is fully dedicated to China equities expertise. Their local presence and local background provide a strong edge in the interpretation of political, economic and social nuances in China. The investment team follows an active, high conviction, bottom-up investment approach, using a disciplined research process and performing deep fundamental analyses (including ESG assessment) and solid risk management. The team believes that investing in companies delivering sustainable, high quality earnings growth at an attractive price, and presenting sound or improving ESG profiles, drives alpha over the long term.

The Emerging Markets Fixed Income (EMFI) team is responsible for Chinese fixed income investment and has a well-established and successful track record since 2010 of investing in the onshore RMB bond market.

The team of 16 investment professionals based in London, Hong Kong, Singapore and Kuala Lumpur manages a total of USD 5.0 billion (as of 30 June 2019) across a range of emerging markets fixed income strategies. The team allocates dynamically to the most attractive segments of the onshore Chinese bond market and seeks to generate returns through duration and yield curve positioning, sector allocation and security selection. While being largely invested in treasury and policy banks bonds given the current investment outlook and market opportunity, it can and does also invest in the rapidly evolving onshore credit market.

17 Source: BNPP AM, as of 30 June 2019.

ABOUT THE AUTHORS

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Caroline has been leading the Greater China Equity strategy within BNPP AM since July 2015 and has been working within the financial services industry since 2003. She and her team won three awards at the Benchmark Fund of the Year Awards 2018:

1) House Award Greater China Equity (Best-in-Class) in Hong Kong,
2) House Award Greater China Equity (Best-in-Class) in Singapore,
3) Caroline won the title of "Manager of the Year" for Greater China Equity in Singapore.

In 2019, her team won additional awards from:

1) Insurance Asia News, Institutional Asset Management Awards 2019 as "Best Equities Manager of the Year - Greater China Equities",
2) The Asset's "Triple A Awards 2019" as "Fund Manager of the Year".

Prior to joining BNPP AM, Caroline worked at Henderson Global Investors as the Lead Portfolio Manager for the Henderson Horizon China Fund. The fund was awarded the 2015 Lipper Fund Award for Best Fund over 3 Years for Equity Greater China, and was consistently ranked in the 1st quartile by Morningstar (EEA OE China Equity Category) in each of the three years from 2012 to 2014. In addition to her expertise in investment management, Caroline brings valuable experience and insight from her prior roles as a Financial Analyst with General Motors China and a Business Analyst at Prosys Solutions and corporate finance manager at Elementis PLC in London. She holds a Master of Business Administration degree (majoring in Finance) from the London Business School. She has a Master of Science degree in Business System Analysis and Design from the City University in London. Caroline is a CFA® charter holder and a member of the United Kingdom Chartered Financial Analyst society. ■

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Chi is BNPP AM's Senior Economist for Greater China and is based in Hong Kong. Prior to joining BNPP AM, he was Head of Overseas Investment at Ping An of China Asset Management (HK) Ltd. Chi's other positions in Asia included Asia Research Head for the British private property fund Grosvenor, chief economist and strategist for Asia at Standard Chartered Bank and research director for Greater China at HSBC in Hong Kong. Before working in Asia, Chi was an economic advisor to the Canadian Treasury in Canada. His other experience includes international research firms in North America, regulatory bodies for securities trading in Toronto and London, and blue-chip international investment banks in North America, the UK and Asia. Chi is the author of 11 books on Chinese and Asian economic development and markets. His latest book is "Demystifying China's Mega Trends: The Driving Forces That Will Shake Up China and the World" (2017). Chi did his economics graduate work at the London School of Economics and Political Science (LSE) in England and the University of British Columbia (UBC) in Canada. ■

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Jessica works closely with the investment team to market the team's capability to sales and clients globally. Prior to this, Jessica first joined BNPP AM in Paris as a portfolio manager assistant in the Sustainable and Responsible Investment equities investment team. Before joining BNPP AM, she held two different positions in BNP Paribas Wealth Management in Hong Kong in 2012: 1) the Strategy and Business Development team, 2) the Investment Funds Advisory team. Jessica holds a Master's degree in Management and a 'Diplôme des Grandes Écoles' with a major in Finance from the NEOMA Business School in France. ■

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Jean-Charles is the Deputy Head of Emerging Market Fixed Income (EMFI) at BNPP AM. In this role, he is responsible for supporting the management of all EMFI portfolios and developing a unified EMFI investment process. Jean-Charles joined our firm in 2016 and is based in London.

Prior to joining us, Jean-Charles was at the Institute of International Finance (IIF) where he served as Asia-Pacific Regional Director and CEO of IIF APAC Ltd in Singapore. Before that, he was a Senior Portfolio Manager and Head of Emerging Markets Fixed Income for Everest Capital, where he was responsible for the launch and management of an absolute return emerging market debt fund as well as a long only frontier markets fixed income fund. Prior to that, he worked as a Senior Vice President in the EMFI Team at Trust Company of the West (TCW) in Los Angeles.

Jean-Charles has 18 years of investment experience. He is an alumnus of Ecole Normale Supérieure. He holds a BA in Economics and Philosophy and a Master's degree in Epistemology and Philosophy of Economics from Sorbonne University. He also holds a Master's degree in International Economics from UPMF in Grenoble, France. ■

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Karan is an Emerging Markets Fixed Income Investment Specialist at BNPP AM. In this role, he is responsible for enhancing and commercialising the emerging markets fixed income proposition as well as engaging with clients to effectively communicate our offering and service client needs. Karan joined our firm in 2017 and is based in Hong Kong.

Prior to joining us, Karan was a Senior Investment Consultant at Willis Towers Watson, where he headed the Emerging Market Debt and Global Fixed Income asset manager research team. His responsibilities also entailed undertaking client engagement, researching financial markets and formulating client solutions. Karan has 10 years of investment experience. He holds a Bachelor of Science (Cum Laude) in Business Administration with a concentration in Investments and Financial Markets from the University of Southern California as well as a Master of Science (Distinction) in Finance from Cass Business School. Karan is a CFA® charterholder. ■

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