

# China markets

The outlook for China equities and fixed income

**Bin Shi, Head of China Equities**

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How will China's stock and fixed income markets & indexes perform in H2 2019 and 2020 as the global economy slows? Our three China experts give their key views to investors and look ahead to investing trends for the next 18 months.

## **Our views – in 60 seconds**

- China's economy is slowing, but we expect growth to stabilize and an 'L-shaped recovery in H2 2019';
- Policy will remain supportive. Further RRR cuts, tax cuts and supply-side reforms likely in H2 2019;
- Positive real yields make China government bonds an attractive safe-haven as global growth slows;
- September/October may be a good entry point to invest in China High Yield strategies;
- Equity valuations remain attractive, and we are still positive on consumer, IT, healthcare and insurance sectors as their fundamental drivers remain intact;
- An All-China approach to equity investing may offer investors the best way to combine the best equity investment opportunities in China's onshore and offshore equity markets

# China economy outlook: slower growth – and that's fine

**Hayden Briscoe**  
Head of Asia-Pacific Fixed Income



China's economy is slowing, and so is global growth. The IMF estimates 6.3% growth for China in 2019, compared with 6.6% in 2018, and 3.3% for the global economy in 2019, versus 3.6% in 2018.

## **China's economy: will it continue to slow?**

We don't think China's economy will see a continued slowdown, and that's for a number of different reasons.

Firstly, the policy support rolled out in Q4 2018 is only just starting to be felt in the real economy.

During the next six months, the policy measures taken, including monetary policy easing, tax cuts, and supply-side reforms will start showing up in the official numbers. As such we, expect China's economy to stabilize in H2 2019.

## **Keeps your eyes on China's all-important real estate sector**

Additionally, we're expecting a boost to the economy from China's real estate market. What's happened in the past couple of months is that sales have grown rapidly, but the actual construction of the buildings has fallen behind<sup>1</sup>.

When China's developers get around to building the houses they have sold, we'll see the effect of that activity ripple through the economy and that will deliver a further boost to

the economy in H2 2019 and add further weight to our expectation of stabilizing growth later in the year.

## **China policy moves will come into focus in H2 2019/2020**

We're also expecting further support for the economy.

Looking at China's monetary policy, we're expecting further rate cuts, most likely in the form of cuts to RRR, to come through in H2 2019, which will likely ease the flow of credit into the economy.

What this means for investors is that they will have to get used to a new reality, which we describe as the '3Ls':

- L-shaped recovery: growth will stabilize rather than rebound. Policymakers are wary of adding huge stimulus and are making targeted moves to keep growth stable;
- Longer business cycles: following on from the above idea, the business cycle will likely be longer and more stable because the authorities are taking a more measured policy approach;
- Longer-term quality growth: deleveraging policies and new regulations imposed in 2017 and 2018 have imposed new discipline and forced poor-quality firms out of the market, and that has improved the longer-term outlook for China.

So with these trends playing out, and the prospect of a L-shaped recovery, we actually think that slower growth is fine for China. We'll now turn to how the above trends open up opportunities in Chinese fixed income.

<sup>1</sup> China National Bureau of Statistics, June 2019

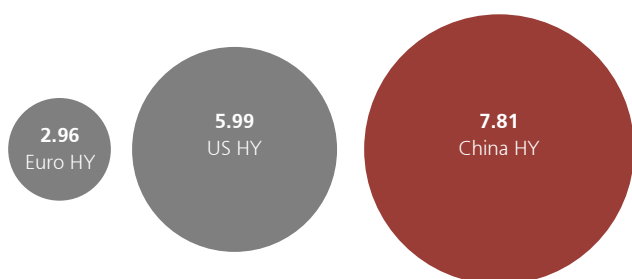
### China fixed income: two essential trends and trades

Investors face a difficult problem: where do you hide out as the world economy slows?

Developed markets like Germany, Japan and the United Kingdom are offering little or no protection – real yields are negative there and US treasuries aren't offering that much either.

With markets the way they are, China government bonds stand out as an excellent choice.

### High yield benchmarks compared, yield-to-worst (%)



Source: Bloomberg, June 2019

Offering positive real yields and low correlation to developed markets, we believe this asset class has a place in everybody's portfolio and is an emerging safe haven asset of choice for global investors.

And this is an asset class that has performed, racking up a position as one of the top-performing assets globally in 2018, and which we expect will continue to do well.

Moving on, we believe there is an excellent investor case to consider China high yield strategies.

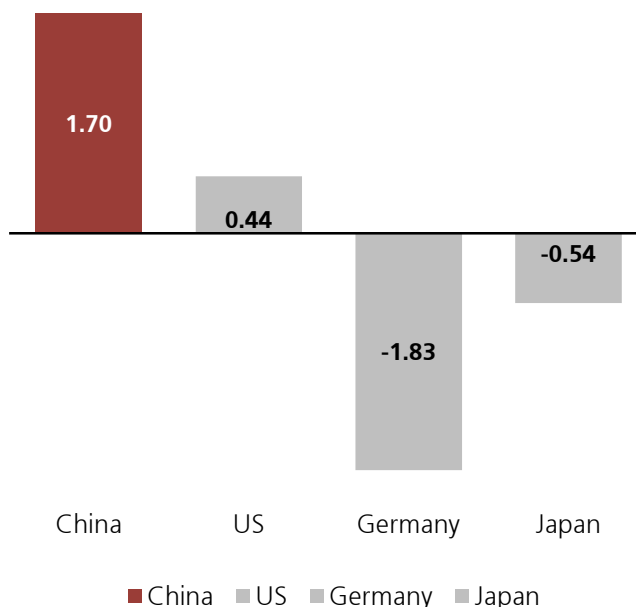
In a world starved of yield, China high yield offers excellent relative value vs. other global high yield markets.

And we see decent fundamentals for the asset class. Real estate companies dominate the issuance universe for China high yield bonds, and we have tracked a pronounced uptick in sales during the past year.

These improved sales trends, coupled with the sustained efforts to deleverage undertaken by some of the larger developers, means we are confident about the asset class and favor the larger players in the space.

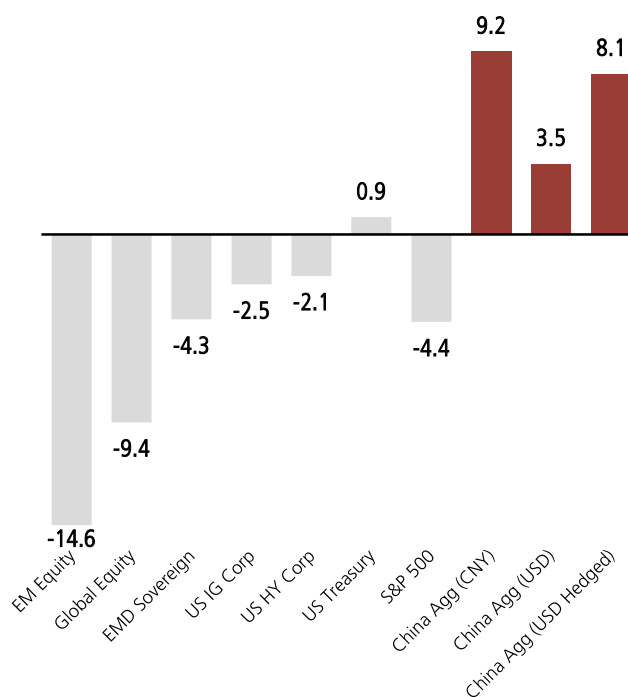
Looking at fundamentals in the economy too, we see an attractive entry point for China High Yield later in Q3 2019. We believe as the economy stabilizes, we'll see an opportunity for capital appreciation too from potential yield tightening.

### Real yields on 10-year government bonds (%), June 2019



Source: Bloomberg, June 2019

### Returns by asset class benchmark (%), FY 2018



Source: Bloomberg, March 2019

# China equities: don't fear volatility, fundamental drivers remain intact

**Bin Shi**  
Head of China Equities



The ongoing trade discussions between China and the US are producing a lot of noise in the media.

This is likely to continue because we don't expect a solution to emerge any time soon. As such, China's stock markets will remain volatile.

## China markets come with volatility

But volatility isn't a new thing to China's stock markets. In fact, China's markets have been volatile for some time now and it is certainly not new to us, the trick is to use it to your advantage.

One way to do that is to stay focused on fundamentals.

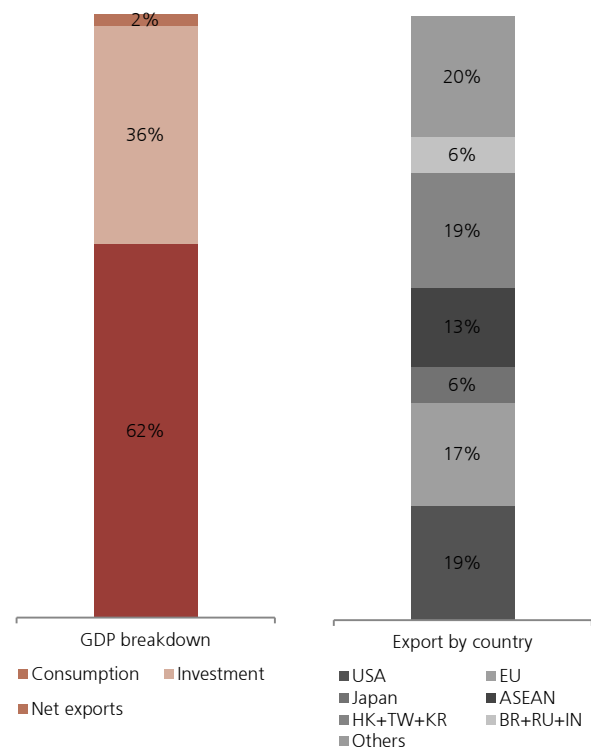
## Cut through the noise, focus on fundamentals

Despite all the noise about trade tensions and concerns about slower growth in China, we'd remind investors that China has limited exposure to US trade.

Looking at the companies making up the MSCI China index, only 1.8% of their revenues come from the US<sup>1</sup>.

Looking at the macroeconomy, net exports account for only 2% of China's GDP, and US exports account for 19% of total exports<sup>2</sup>.

## China 2018 GDP breakdown vs. Export by country



Source: UBS AM, Factset, May 2019

<sup>1</sup> UBS Asset Management, Factset, May 2019

<sup>2</sup> UBS Asset Management, Factset, May 2019

With regard to fundamentals, we are focused on domestic demand and the long-term fundamentals underpinning four main domestic demand drivers remain intact.

The four drivers are :

- **Growing consumer demand:** consumption growth in China remains robust, and many of the consumer names we follow have produced better-than-expected results, despite noise in the media about trade tensions.
- **Continuing urbanization:** China continues to rapidly urbanize rapidly and that's creating large, urban consumer markets and supporting demand for services like education.
- **Automation and innovation:** China's industries now have the biggest stock of installed robots in the world and continued strong investment in R&D means sustained innovation by Chinese companies.
- **China's aging population:** 245.9 million people in China will be aged over 65 by 2030, which we believe will create huge demand for services like healthcare and insurance.

We're confident that these fundamentals still have much more room to grow, and that means opportunities on China's equity markets for disciplined investors.

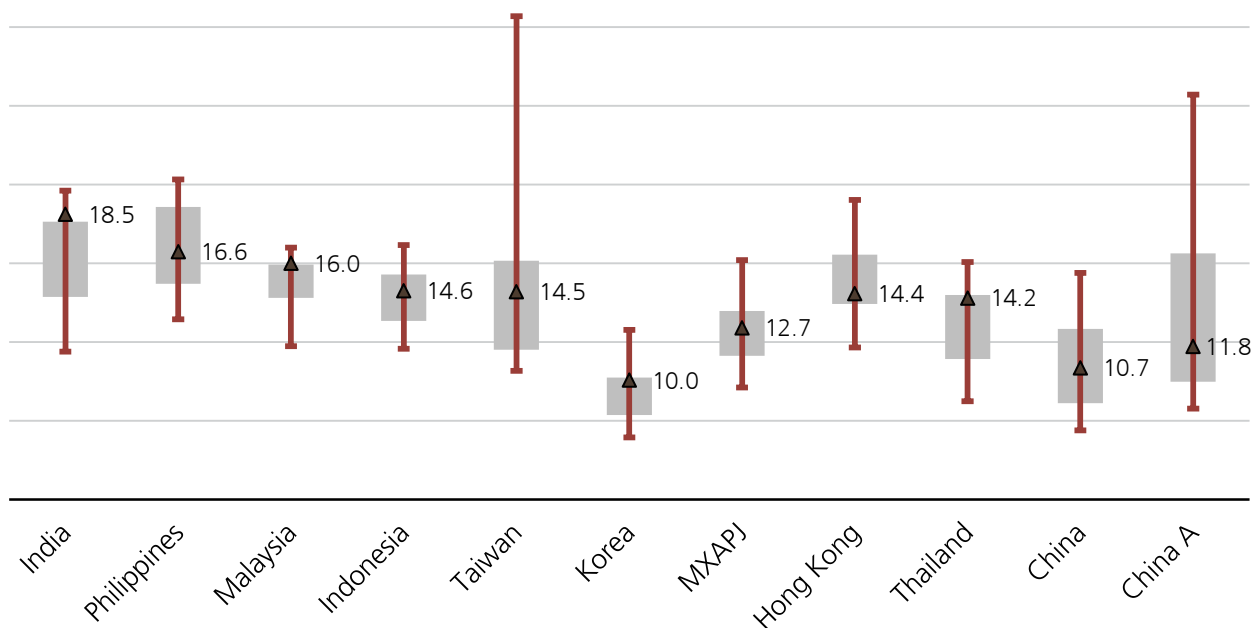
**Take advantage of current valuations; think about strategy**

And current valuations on China's equity markets remain attractive on both historical measures and compared to other markets in the Asia-Pacific region.

The trick then for investors is how to access the best opportunities.

Now that reforms such as Stock Connect have opened up China's onshore equity markets, an All-China approach that allocates to the best equity opportunities whether in onshore or offshore China markets may offer the best way for investors to capitalize on the many opportunities in the China equity space.

**Markets compared: 12M forward price-to-earnings ratio (P/E)**



Source: FactSet, MSCI, UBS Asset Management, data as of end May 2019.

# China multi-asset investing: getting the right balance

**Gian Plebani**  
Portfolio Manager,  
Investment Solutions



When choosing between equity and fixed income assets, we are currently overweight to risk assets, and favor China equities, with particular preference for China A markets.

## **China policy stimulus: supportive, but this time it is different**

At the macro level, we have seen substantial policy stimulus for China's economy, and that's translating into an upturn in leading indicators which we believe will stabilize the economy in H2 2019.

But this recent round of stimulus is different to the huge credit injections seen in 2009.

This time, monetary and fiscal stimulus has targeted capital-efficient private sector corporates rather than highly-indebted property and state-owned enterprise sectors.

We see this as a welcome differentiator and reduces structural capital intensity and the volatility of China's longer-term growth prospects.

## **China investment strategy: overweight risk; prefer equities over bonds**

That's one of the key reasons for our asset allocation strategy.

We favor equities, and particularly China A, because we believe domestic companies in China are better positioned to benefit from the Chinese government's supportive policy measures.

But we still have conviction in China fixed income. We prefer USD denominated HY bonds and we are positive on our exposure to onshore RMB bonds as an efficient diversifier in the portfolio context.

We keep a moderate cash level and have hedged out some of our CNY exposures as the USDCNY rate was hovering around the psychological level of 7 and it could lead to an acceleration of currency depreciation once the level has been passed.

## **China allocation strategy: capturing growth, controlling risk**

We believe this allocation offers the best way forward to benefit from China's growth story - don't forget China's expected to grow at 6.3% - whilst striving to minimize the impact to investors of what we expect will be continued volatility in the markets.

It's this approach to capturing China's growth story but striving to give investors a smoother ride that has served both our multi-asset strategy, China Allocation Opportunity, and our investors well over the years.

And we are confident that our in-depth research, onshore capabilities, and high-conviction views will continue to drive performance.

## **Putting our views together: our China outlook**

- China's economy is slowing, but we expect growth to stabilize and an 'L-shaped recovery' in H2 2019;
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