The Changing Dragon: Exploring Opportunities in China

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Executive summary

China is the world's second largest economy, bond market, and equity market. Yet, its importance seems underrepresented in investor's portfolios. Direct investment in Chinese assets offers significant first-mover advantages to investors who are willing to take advantage before competition rises with greater global index inclusions. This paper examines the historical performance of China's equities and bonds, and highlights the potential alpha that global investors could reap, if they invest in Chinese assets.

China's risk assets are well-positioned to flourish in the post COVID-19 environment: so far China's equity and bond markets have outperformed most other markets, as its domestic demand has rebounded, and with its interest rates far from zero.

It should be noted that geopolitical risks have also increased significantly with the deterioration in US-China relations. This could cause investors to pause. However, the more significant longer-lasting risk is that China's on-going liberalisation of its financial markets, and its rebalancing of the economy, does not feed-through to better returns, especially for long-term equity investors.

Author

Robert St Clair
Strategist
Fullerton Fund Management

» Sizing up a direct allocation to Chinese assets is preferable to market-determined index exposure

Direct investments provide a much stronger tie to China's underlying economic activities and performance. Given China's significant global footprint, index investors won't gain an 'economically representative' exposure until China's weight in key global benchmark indices reaches high double-digits. Not surprisingly then, global investor surveys show that respondents prefer a direct investment in China, as opposed to a benchmark index, because it gives full autonomy over their sector allocations.

» Equity investors can get the best rewards from nimble trading and active management

A common misconception is that China is only an attractive investment destination when its GDP growth is strong. We show statistical evidence that there is no relationship between China's GDP growth rate and its equity market returns – what matters much more is the output gap or business cycle. China's equity returns have performed well during growth decelerations as long as realised growth is above or close to trend (e.g. over the last 10 years China's real GDP growth has fallen from 11.5% to 6.1% p.a. yet its equity returns were 5% p.a.).

To achieve the best performance from investing in China, equity investors need to be nimble and focused on fundamentals that are likely to have an impact over the next 1-3 years. The importance of being nimble reinforces the case for active management strategies, and historical performance data shows that active management of Chinese equities can significantly outperform index-based investments.

China provides alpha opportunities, in particular across higher value-added consumer, technology, e-commerce and healthcare sectors. Investing in China A equities also gives some diversification away from Developed Markets, especially over the longer-term.

» Bond investors can get solid returns and diversification

Because of higher yields versus Developed Markets, China's fixed-income should be attractive to investors seeking solid risk-rewards with a desire to diversify away from Developed Markets. China's fixed-income is also superior to most Emerging Debt Markets because of China's strong sovereign fundamentals, its low correlations with global markets in general, and the likelihood of a favourable risk-reward balance.

» Investors still have to be cautious and selective in the post COVID-19 environment

With the world in the midst of a COVID-19 recession, China seems well-placed to drive the global recovery while the rest of Asia, the US, and Europe, will lag. Very low Developed Market yields driven by Quantitative Easing policies should make China's bond returns even more attractive. China's equities may continue to outperform other countries, as we have seen so far this year, as its domestic demand rebounds.

However, the latest deterioration in US-China relations is very concerning and creates significant uncertainties for investors – especially those considering making greater allocations to China or Hong Kong. As a result, investors are likely to pause and wait for more clarity on how US-China relations will unfold.

Looking beyond greater geopolitical risks, as China continues to rebalance its economy, its risk-adjusted equity investment returns should become more appealing to longer-term investors. With the benefit of on-going economic rebalancing, if China's equity market returns can become less business-cycle/output-gap centric, then longer-term returns can improve and more importantly, volatility can fall.

Why sizing up a direct allocation to Chinese assets is preferable to market-determined index exposure

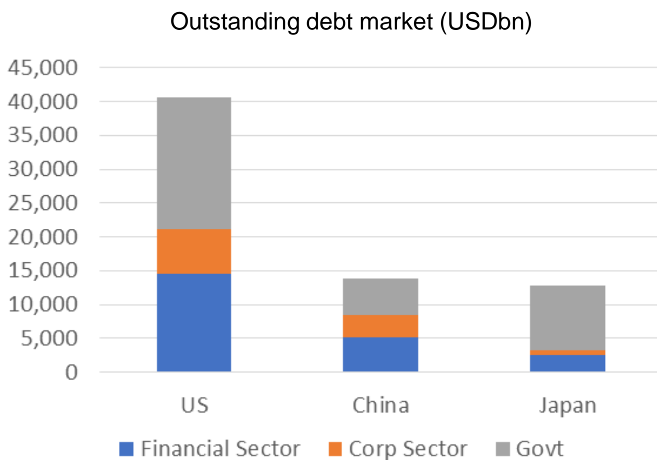
Chinese bonds still undergoing phased inclusion into global indices

China's bonds were first added into the Bloomberg Barclays Global Aggregate Index on 1 April 2019, and by November 2020, with full inclusion, will comprise around 6% of the index. The Chinese Yuan (CNY) will become the fourth-largest index component after the US dollar (USD), the Euro (EUR), and the Japanese Yen (JPY).

More recently, a phased inclusion of Chinese government bonds into JP Morgan's Emerging Market indices (GBI-EM suite) started on 28 February 2020 with an additional 1% weighting per month, until a terminal weight of 10% is reached after 10 months. Driven by the inclusion, JP Morgan analysts have predicted that around USD20bn in additional funds may flow into the Chinese bond market by the end of 2020.

Fixed-income index inclusion has certainly boosted capital inflows into China. Since the first quarter of 2019, China's bond market has grown by USD1.8tn, while international investor holdings of Chinese bonds increased by more than 20% (around USD 50bn), overtaking Japan and making it the second largest bond market in the world behind the US (See Figure 1).

Figure 1: Global bond markets



Source: BIS data as at Q3 2019, from the BIS March 2020 update

Chinese equities are significantly under represented in global equity indices

China's local equity market (i.e. China's A-shares - its domestic shares of mainland-based companies listed on the Shanghai and Shenzhen Stock Exchanges) is also the second largest in the world, both by market capitalisation and turnover measures (see Figures 2 and 3).

Figure 2: Global share markets by market cap and number of listings

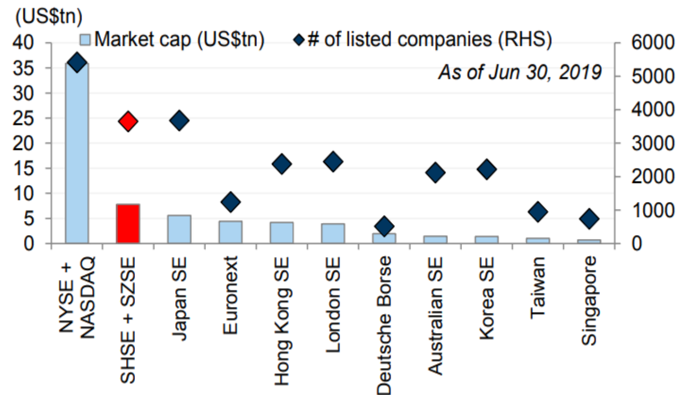
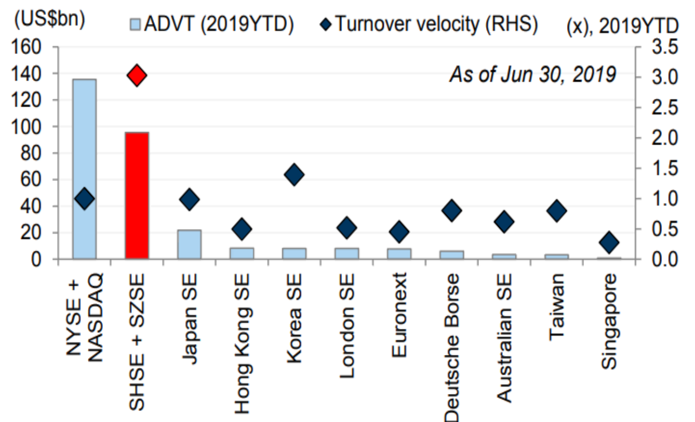


Figure 3: Global share markets by cash turnover

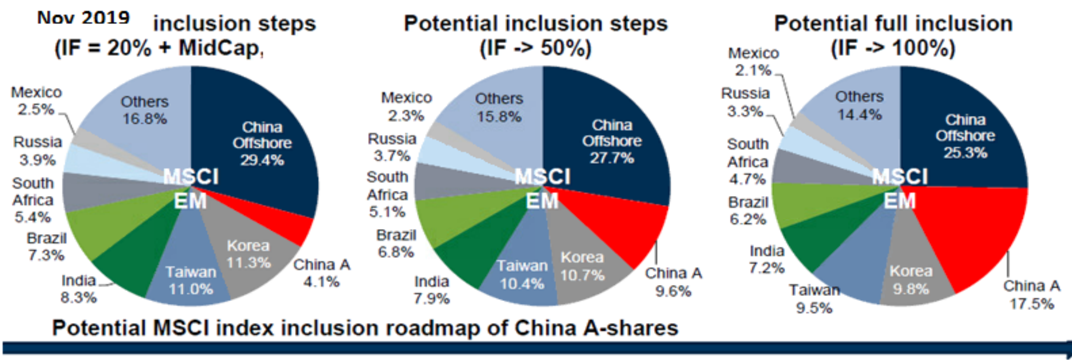


Source: WFE, compiled by Goldman Sachs, September 2019

As in the case of bonds, China's weight in key global benchmark equity indices has also been rising, but it has been a slow process from a very low base weight. Since late last year, the MSCI inclusion factor for China's A-shares reached 20% giving it a weight of 4.1% in the MSCI Emerging Market Equity index (see Figure 4).

Encouragingly, when China achieves full MSCI inclusion its domestic share markets will have a weight of around 18% in the MSCI Emerging Market index, though the timeline for this is unknown. Drawing on the experiences of South Korea and Taiwan, full inclusion of China's A-shares in the MSCI Emerging Market equity indices could take another 3-5 years at least.

Figure 4: China's weight in MSCI Emerging Markets Index

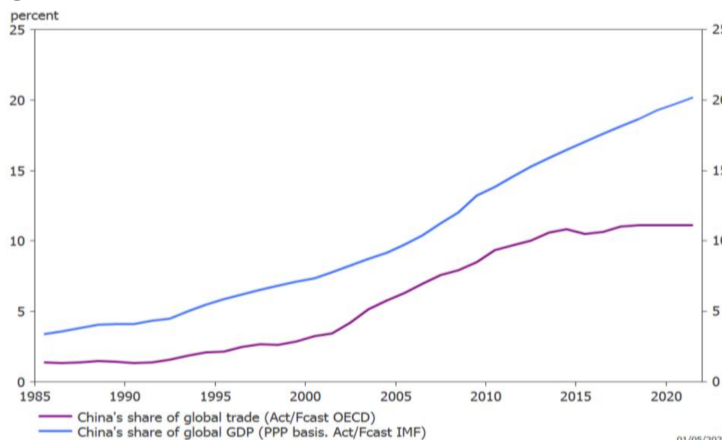


Source: FactSet, MSCI, Goldman Sachs, September 2019

There are more than 3,500 China securities listed on the Shanghai and Shenzhen Stock Exchanges. Until there is much greater MSCI inclusion, hundreds of stocks will remain unrepresented to index investors.

Despite China's weight in global investment indices rising over recent periods, it is still relatively low considering the global importance of China's capital markets, and China's large share of global trade, especially global GDP (see Figure 5). As China continues to rebalance its economy more toward domestic demand, its share of global trade may remain flat, but its share of global economic activity will continue to trend higher.

Figure 5: China's weight in global trade and GDP



Source: Refinitiv DataStream, May 2020

This argument was reinforced by the recent China Position Survey[1] by the Economist Intelligence Unit (November 2019) which found that nearly 90% of respondents have a dedicated investment exposure to China, where 'dedicated' means investments that are deliberately China-specific and not acquired through broader holdings such as regional allocations or Emerging Market Funds. One reason investors prefer a dedicated investment, as opposed to a benchmark index, is they have full autonomy over their sector exposure.

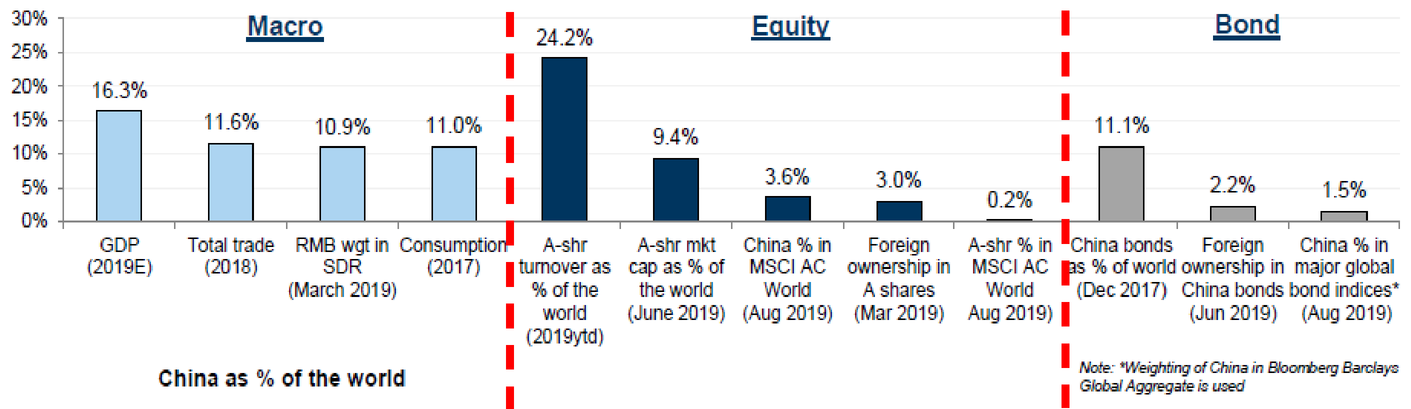
> **Given the significance of China's global foot-print, it can be argued that index investors won't gain an economically representative exposure until China's weight in key fixed-income and equity indices reaches high double-digits.**

[1]The China Position by the Economist Intelligence Unit is a survey of 411 global asset management firms, with 22% across Europe, 15% from the UK, 13% from the Middle East and Africa, 25% across North America, and 25% from Asia-Pacific. Respondents encompassed banks, endowment funds, family offices, government agencies, hedge funds, insurance and reinsurance companies, pension funds, and sovereign wealth funds. Assets under management at the surveyed organisations ranged from USD500mn to greater than USD10bn (with 44% of the respondents having AUM of USD10bn or more, and 9% of respondents with AUM of USD100bn or more). Copyright notice: "© November 2019. The Economist Intelligence Unit Ltd. All rights reserved. disclaimer: Whilst efforts have been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor its affiliates can accept any responsibility or liability for reliance by any person on this information.

China provides first-mover advantages and significant potential rewards for investors

Given the scale of China's capital markets, its foreign ownership stakes are very low – with just 2.2% bond-holdings and 3.0% for equities (see Figure 6).

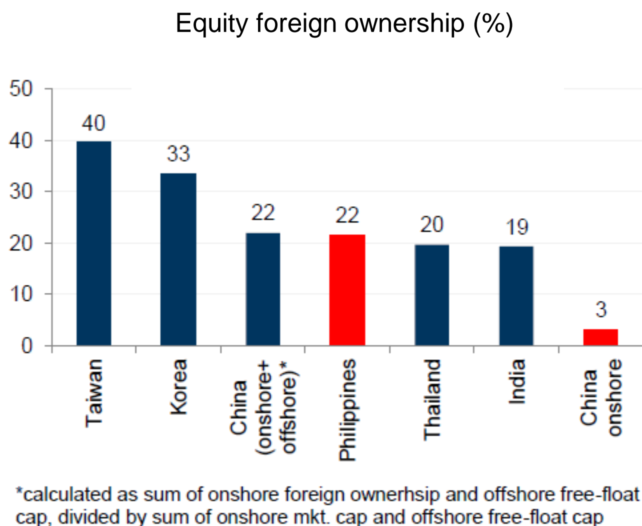
Figure 6: China's shares of global macro, equities, and bonds – with foreign ownership stakes



Source: Goldman Sachs, September 2019

China's foreign investor participation in equities is also low compared to foreign participation in other Asian markets (see Figure 7). Low participation creates first-mover advantages for investors considering a China exposure. For example, adding Chinese bonds to a portfolio of Developed Market bonds can be a rewarding strategy before index inclusion advances too far and correlations with Developed Markets rise.

Figure 7: Equity foreign ownership of China and other Asian markets

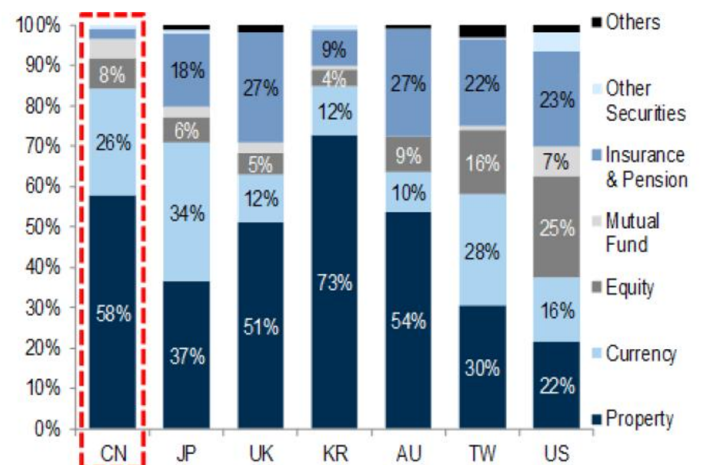


Source: Goldman Sachs, September 2019

Furthermore, there is evidence that China's household holdings of equities is also low compared to other markets (Figure 8) which creates opportunities for both foreign investors and fund managers (with plenty of scope for the latter to present more investment product options to Chinese households).

With such a low-base of foreign participation China's policymakers are constantly seeking ways to encourage more foreign investment. For example, there are significant tax advantages for foreign investors. In the onshore Chinese government bond market, they are currently exempted from income tax and value-added tax on capital gains as well as on coupon income.

Figure 8: Composition of household assets



Source: Goldman Sachs, September 2019

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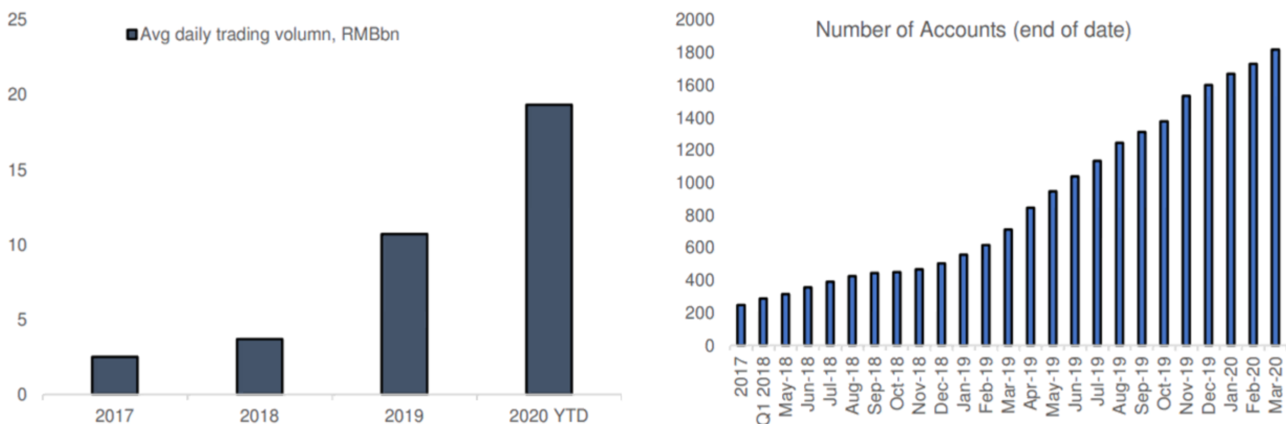
The China Interbank Bond Market Direct (CIBM) scheme allows investors access to Chinese Yuan derivatives such as interest rate swaps and bond repos. Bond Connect (launched in 2017) is a channel enabling international investors to trade domestic bonds onshore, without quotas, on global trading platforms. The appeal of Bond Connect has increased (see Figure 9) over time with its integration into the Bloomberg trading platform.

Figure 9: Measures of Bond Connect participation



Source: Deutsche Bank, April 2020

Over the years ahead, as China continues to liberalise and open-up its capital markets, its 'foreign-investor friendly' initiatives will help underpin greater investor participation but will also slowly increase competition for the most attractive deals.

As investor competition rises over time, it will become increasingly important for investors to seek alpha from a thorough fundamentals-driven asset selection process. There is strong evidence that investors looking to allocate more funds in China should pursue an active management strategy.

A scan of actively managed China A-share strategies in Mercer's Global Investment Manager Database shows that the median active manager generated 5.2% in gross excess returns over the last 12 months (versus the MSCI China A index, see Figure 10). Upper quartile managers generated very strong excess returns (12.2% over the last 12 months), while even lower quartile managers were able to generate up to 4.4% in excess returns.

Figure 10: Excess returns from active managers versus MSCI China A (% points)

Group Statistics	1 yr	3 yrs	5 yrs	Since May 2006
Upper Quartile	12.2	14.6	12.0	6.0
Median	5.2	11.4	10.9	6.0
Lower Quartile	4.4	8.4	9.6	5.9

Source: As at March 2020, from Mercer LLC. All excess returns, versus the MSCI China A Index, are in USD, before fees. Returns in excess of one year are annualised. It is not an official Mercer universe release and this output should be read in conjunction with, and is subject to, Mercer Insight MPA™. Past performance is not necessarily indicative of future returns.

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The *China Position Survey* by the Economist Intelligence Unit highlighted that “improvements to my organisation's China expertise” was reported as the top driver needed for an effective China investment exposure. Having an onshore research presence can play a key role in the early discovery of growth sectors and companies to invest in across China’s economic value-chain.

Active security selection in China is also important because China’s corporate governance standards are still improving. In the past, well-publicised fraud cases, such as Luckin Coffee, have hurt foreign investor confidence. While China’s transparency and governance still has some way to go to reach Developed Market standards, China’s policymakers are pushing forward with reforms. For example, China’s Securities Regulatory Commission (CSRC) published a new Code on Corporate Governance (2018) which makes audit committees mandatory and provides better safeguards for minority shareholders. Reporting standards for China A-listed equities have been made more stringent, and in many ways are now more onerous than Hong Kong’s listed equities.

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Diversification appeal of Chinese assets to international investors

Onshore bond markets exhibit low correlations to major bond and equity markets

The onshore Chinese bond market exhibits very low correlations to major bond and equity markets, increasing its appeal to international investors looking to diversify from their core asset classes (see Figure 11). The low correlation is a reflection of small foreign ownership, and the fact that China's business cycle is very different to other major economies.

Figure 11: China bond correlations with global markets

Period	Global Equities	US Equities	Global Govt Bonds	US Treasuries	Euro Aggregate	Swiss Govt	UK Gilts	EM LC Bonds	EM Corp Bonds
3 years	0.1	0.1	0.2	0.1	0.1	0.0	0.1	0.2	0.1
5 years	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10 years	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.1

Source: Bloomberg, based on weekly correlation from the respective period to 24 April 2020. Indices used are MSCI World Index (Global equities), S&P 500 (US equities), FTSE World Government Bond Index (Global government bonds), Bloomberg Barclays US Treasury Total Return (US Treasuries),Bloomberg Barclays Euro Aggregate Total Return Index in EUR (Euro aggregate), Bloomberg Barclays UK Government All Bonds Total Returns in GBP (UK Gilt), Bloomberg Barclays Series-E Switzerland Government All > 1 Year Bond Index (Switzerland Government), JPM GBI-EM Global Diversified Index (Emerging market local currency government bonds), JPM CEMBI Broad Diversified Index (Emerging market corporate), IBoxx CNY Onshore Bond Index (onshore China government bonds).

For example, before the COVID-19 crisis this year, China's GDP growth had never fallen since 1976. China's growth has been 'out-of-phase' with the rest of the world in part because of the rise of its middle-class spending, as well as because China's policy objectives are quite different from Developed Market countries. China places significant importance on improving the quality of its growth over time, and tries to strike a balance between greater development and poverty reduction. China's policymakers are also focused on opening the financial sector, and rebalancing the economy away from trade and toward services.

Investing in China A-shares provides significant diversification from Developed Market equities

China's equity market correlations with global markets have been rising over time and are much higher than bond correlations, but are still modest (see Figure 12). A key reason China's equity correlations are much higher is because a common link across equity markets is earnings growth, and China makes a significant contribution to global GDP growth and therefore to the cycle in global earnings (see Figure 13). That said, investing in China A equities gives some diversification away from Developed Markets, such as the US, the UK, Europe and Japan, especially over longer-term periods.

Figure 12: China equity correlations with global equity markets

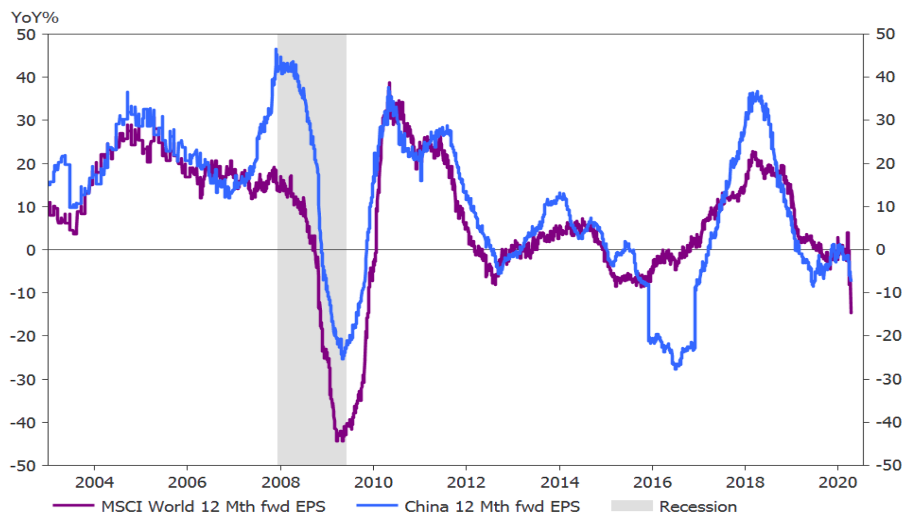
Last 10 years	World	China A	China	Asia ex Japan	Europe	Japan	US
World							
China A	0.36						
China	0.67	0.59					
Asia ex Japan	0.78	0.49	0.93				
Europe	0.91	0.29	0.59	0.69			
Japan	0.72	0.29	0.54	0.62	0.68		
US	0.97	0.31	0.57	0.67	0.81	0.60	
UK	0.87	0.29	0.57	0.68	0.94	0.63	0.79

Last 5 years	World	China A	China	Asia ex Japan	Europe	Japan	US
World							
China A	0.43						
China	0.70	0.65					
Asia ex Japan	0.81	0.57	0.94				
Europe	0.88	0.37	0.61	0.71			
Japan	0.76	0.35	0.60	0.68	0.77		
US	0.97	0.39	0.61	0.71	0.76	0.64	
UK	0.83	0.32	0.57	0.67	0.93	0.67	0.73

Last 3 years	World	China A	China	Asia ex Japan	Europe	Japan	US
World							
China A	0.51						
China	0.69	0.73					
Asia ex Japan	0.82	0.69	0.94				
Europe	0.87	0.46	0.60	0.72			
Japan	0.80	0.43	0.59	0.70	0.81		
US	0.98	0.46	0.63	0.74	0.76	0.71	
UK	0.83	0.42	0.55	0.67	0.94	0.75	0.73

Source: FactSet, based on daily returns, as at 24 April 2020. Shaded correlations are lowest 20% of the group. The benchmarks used are MSCI AC World, MSCI China A Onshore, MSCI China, MSCI AC Asia ex JP, MSCI Europe, MSCI Japan, MSCI USA, and MSCI United Kingdom.

Figure 13: China and global earnings



Source: Refinitiv Datastream, April 2020

Chinese assets offer a valuable source of alpha

Strong fundamentals make China unique

As China's markets continue to grow they will ultimately become key pillars of the global investment space. China's sovereign fundamentals, in particular, are very strong:

- a high national savings rate
- sovereign debt is less than 60% of GDP
- a net external creditor to the world
- an economy that is increasingly powered by domestic consumption rather than exports

As China rebalances itself away from its dependence on heavy industries, and pushes to be a global leader in hi-tech sectors under its 'Made in China 2025 plan', spending on R&D from electronics to science is growing. With the government's focus on healthcare, as both a social priority and a strategic objective, China's pharmaceuticals industry has become a world-leader and a major market for health-related multinational companies.

Numerous studies have estimated that China's share of global middle-class consumption has increased to just behind the US (e.g. IPE, September 2019). E-commerce, in particular, is highlighted as being more significant in China than in the US.

China is a global technology and innovation hub and is much more integrated with global financial markets, industry, and trade, than many other countries. Technology and e-commerce giants such as Tencent and Alibaba are recognised today as global leaders and innovators in their field.

As China's middle-class continues to rise in its importance it is not just consumption-linked investments that can do very well but also investments linked to banks and insurance companies (i.e. as China's middle-class drives stronger demand for financial products and retirement-linked investing).

From the *China Position Survey* by the Economist Intelligence Unit, investment managers were most excited about China's rising position as a global leader in IT, technological development, and innovation (such as artificial intelligence and robotics). This segment was judged by almost 60% of respondents as a key investment 'pull-factor' most likely to attract new investment flows into China, followed closely by financial services, and "New Economy" services such as healthcare, education, and renewable energy.

What all this means for investors is that China provides opportunities to access higher value-added consumer sectors (with strong brands and market share), as well as global leaders in technology, e-commerce, and healthcare.

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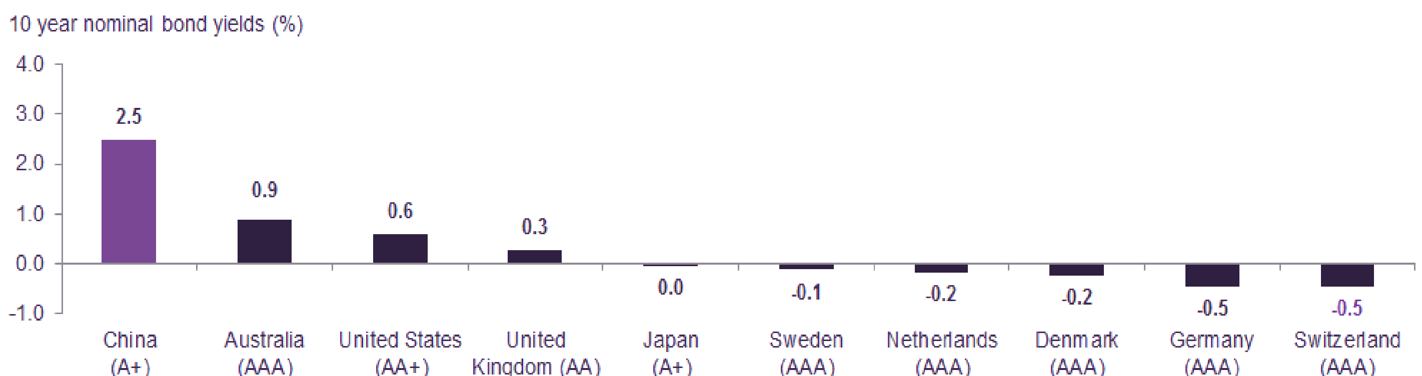
China's nominal bond yields are more favourable compared to similar sized bond markets

China's nominal yields are much more favourable in comparison to similar sized bond markets such as Japan (and with a similar credit rating) and to the much larger US market (Figure 14). This performance gap is likely to widen as Developed Market yields have fallen further with the COVID-19 driven recession. Based on the trend in China's historical government bond returns, the asset class should remain attractive to investors seeking solid risk-rewards, and with a desire to diversify away from Developed Markets. China's government bonds at most horizons have outperformed the UK and Europe with similar or lower volatility (see Figures 16 and 17).

While the yield on Chinese bonds is higher than yields across Developed Market countries, there is less advantage in comparison to Emerging Market Debt. China's fixed-income can be a good substitute for Emerging Market Debt because of China's stronger fundamentals (especially its sovereign wealth and low government debt-to-GDP ratio), its low correlations with global markets, and the likelihood of a favourable risk-reward balance.

Given sound balance sheets and access to funding channels, China's Investment Grade Credit is well-placed to continue to outperform Asian Investment Grade and Emerging Market Investment Grade Credit with potentially similar or lower volatility (see Figures 16 and 17). China's Investment Grade Credit has also been a very competitive substitute to US High Yield Credit: its 10-year relative underperformance is marginal – but with much lower return volatility - while China's Investment Grade outperformed US High Yield at 3 and 5-year holding horizons. China's Investment Grade Credit could continue to give investors Developed Market 'High Yield like' returns but with only Investment Grade credit-risk.

Figure 14: China's nominal bond yields compared to other Developed Markets



Source: Bloomberg, 24 April 2020

Because default rates will rise significantly with the COVID-19 driven recession, investors need to remain selective, but China's High Yield Credit could continue to outperform Asian and Emerging Market High Yield Credit, as China's recovery in demand growth seems more advanced.

Across the suite of China's fixed income, other potential alpha opportunities include duration, curve and sector selection. The 5-year to 10-year rate duration buckets should be key beneficiaries of continuing bond index inclusions. Caution is warranted on duration outside this range, given supply headwinds to come with the large fiscal boost expected in FY2020.

From the sector perspective, Chinese Policy Bank Bonds, which are fully owned by the Chinese government, offer an attractive yield pick-up over equivalent Chinese government bonds. Liquidity is also better, given that the stock of Policy Bank Bonds is comparable to that of the China Government Bond market. In addition, offshore investors enjoy a 3-year tax exemption, until November 2021, which makes the case for investing in Policy Bank Bonds even more compelling.

As China continues to liberalise foreign access to its onshore bond markets, hedging alternatives via derivatives will also become more accessible. Currently, Foreign Exchange (FX) hedging via FX forwards is available to foreign investors. Access to interest rate derivatives, particularly bond futures, will be more gradual as the Chinese policymakers favour foreign investments via cash bonds (rather than synthetic replication using derivatives).

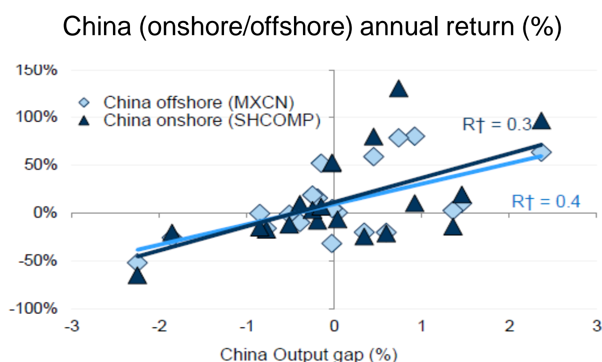
As the onshore bond market, and the credit rating industry, further develops, we foresee greater credit differentiation amongst the onshore credits. We expect liquidity and default risks to persist amongst the smaller privately-owned enterprises, especially as the global recession unfolds. Therefore, in this environment, Chinese state-owned enterprises (SOEs) and larger, fundamentally-strong, private-owned enterprises, may give better risk-adjusted rewards. The latter also stands to benefit from policy support and better access to diversified funding channels.

> **Sound balance sheet fundamentals could continue to underpin strong returns from China's Investment Grade Credit, but investors need to be more cautious on High Yield Credit as default rates rise with the COVID-19 driven recession.**

Equity investors need to be nimble to take advantage of shifting conditions

When trying to consider investment opportunities it is always very difficult to find macro variables that give a reasonable signal on equity market performance. A more micro perspective dictates that earnings growth, tax regimes, valuation, liquidity, and sentiment, are all critical drivers of equity returns. From the macro perspective what also seems to matter to China's equity market performance is conditions over its 3-year business-cycle as reflected in measures of the output gap (i.e. demand growth relative to supply) rather than the GDP growth rate per se (see Figure 15).

Figure 15: Regression of China's output gap against equity returns



Source: Haver Analytics, Bloomberg, MSCI. Compiled by Goldman Sachs, November 2019

Our analysis of China's historical returns shows that China MSCI has outperformed MSCI Asia ex-Japan across all time periods with similar volatility. Over the last 3-years, China's equity returns are higher than Developed Market equities but the volatility is also higher (see Figures 16 and 17).

> **"China's historical equity returns suggest that investors need to be nimble, to take advantage of shifting conditions along the business cycle, and focus most on fundamentals likely to impact over the next 1-3 years. The importance of being nimble reinforces the case to seek alpha from active management strategies.**

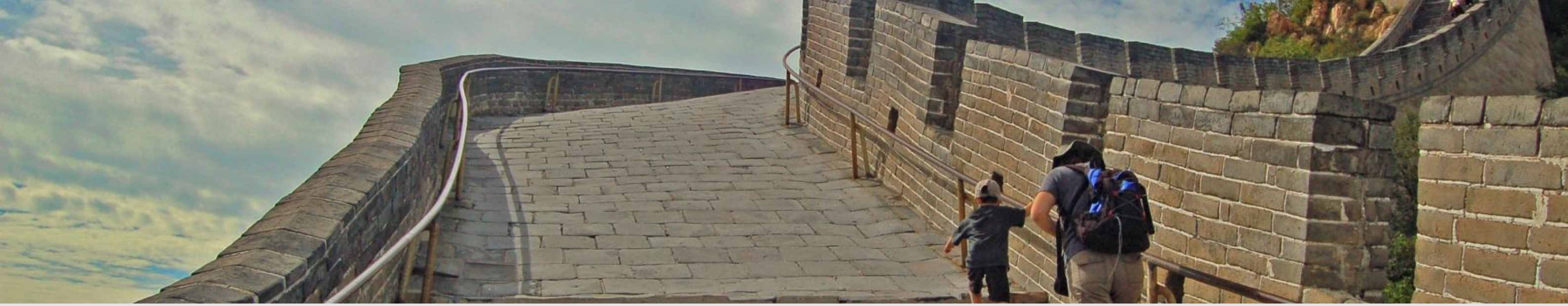
Figure 16: China's historical return performance versus select benchmark indices

Asset Class	10y Annualised Return % p.a.	5y Annualised Return % p.a.	3y Annualised Return % p.a.	10y Annualised Volatility %	Currency
Asia Corp Bonds	5.2	3.7	3.2	5	USD
Asia IG	4.9	3.9	4.3	5	USD
Asia HY	5.9	3.3	-0.3	8	USD
China Corp Bonds	3.9	4.3	4.6	4	CNY
China Corp Bonds	4.1	2.4	4.6	4	USD
China HY	6.6	5.1	1.1	10	USD
China IG	5.3	4.3	4.9	5	USD
EM Corp Bonds	4.7	3.2	1.6	7	USD
EM HY	4.5	3.3	-0.4	10	USD
EM IG	4.8	3.2	3.0	6	USD
US Corp Bonds	4.9	3.4	4.2	5	USD
US HY	5.6	2.8	0.8	9	USD
CHF Gov Bond	2.6	1.1	1.4	3	CHF
China Gov Bonds	4.2	5.1	5.5	5	CNY
EM Gov Bonds	7.2	6.6	6.6	5	LC
EUR Gov Bonds	3.7	1.4	2.3	4	EUR
UK Gov Bonds	6.2	5.0	4.9	6	GBP
US Gov Bonds	3.8	3.6	5.8	3	USD
World Gov Bonds	3.7	2.8	4.1	3	LC
MSCI Asia Ex Japan	4.1	1.7	1.3	17	USD
China A50 Equities	3.8	1.1	8.4	27	USD
China A50 Equities	4.2	3.8	9.5	25	CNY
MSCI China	4.6	3.7	7.2	19	USD
MSCI China	5.0	6.5	8.2	19	CNY
MSCI DM Equities	7.2	3.8	2.5	14	USD
MSCI EM Equities	1.0	0.0	-1.3	18	USD
S&P 500	10.5	6.7	5.1	13	USD
MSCI World Equities	6.5	3.4	2.0	14	USD

Source: Bloomberg. Data is based on daily returns, as at 20 April 2020. Shaded returns are within the top 25% of the sample of 28 investment indices. The 28 benchmarks used are: JPM Asia Credit, JPM Asia IG Credit, JPM Asia HY Credit, JPM JADE Broad China Onshore Bonds, Bloomberg Barclays China Aggregate Credit, Bloomberg Barclays China HY Credit, Bloomberg Barclays China IG Credit, JPM CEMBI Broad Diversified Index, JPM CEMBI Broad HY Diversified Index, JPM CEMBI Broad IG Diversified Index, Bloomberg Barclays US Corp Bonds, Bloomberg Barclays US HY, Bloomberg Barclays Series-E Switzerland Government All >1 Year Bond Index, IBOXX CNY China Onshore Government Bond Index, JPM GBI-EM Global Diversified Index EM Government Bonds, Bloomberg Barclays EU Aggregate, Bloomberg Barclays UK Government All Bonds, Bloomberg Barclays US Treasury, FTSE World Government Bond Index, MSCI Asia Ex Japan, FTSE China A 50 Index, FTSE China A 50 Index, MSCI China, MSCI China, MSCI World - DM Equities, MSCI EM Equities, US S&P500, MSCI AC World. All equity market returns are under the assumption that dividends are reinvested in the index. Past performance is not necessarily indicative of future returns.

Figure 17: China's risk-return profile versus global assets over the long-term.

Source: Bloomberg. Data is as at 20 April 2020 and daily risk-returns are over the last 10 years. The full list of the 28 benchmark indices used is in Figure 16. Mnemonics here are: GB is government bonds, CB is aggregate corporate bonds, IG is investment grade, HY is high yield, China A50 is the FTSE A-share 50 index, EM is Emerging Markets, DM is Developed Markets, WD is the world, CHF GB is Switzerland government bonds, and the $ sign denotes in USD-terms. Past performance is not necessarily indicative of future returns.



Investors still have to be cautious and selective in the post COVID-19 environment

Encouragingly, China seems to have contained the spread of the COVID-19 virus, and the 'sudden-stop' in its economic activity has reversed as factories have returned to work and restored their capacity.

China seems well-placed to lead the global recovery while the rest of Asia, the US, and Europe, will lag.

Recovery creates buying opportunities

The recovery will create buying opportunities. However, investors will still have to be cautious and selective given the risk that the post COVID-19 environment is fundamentally different from before. There will be potentially less globalisation and more social distancing (resulting in lower spending on tourism and discretionary retail, and more spending on utilities, healthcare, technology, and consumer staples).

With the rising importance of China's domestic demand, the economy is flexible enough to meet the changing needs of consumers. Sophisticated on-line shopping networks, and innovative technologies will make significant contributions to Work From Home/social distancing e.g. China's 5G roll-out will immediately create the world's largest 5G network, ahead of the US. As healthcare spending becomes much more important to the global economy, China's pharmaceutical industry is well-positioned to extend its global market share.

The very low global yield environment, especially as key Developed Market central banks pursue QE-based stimulus, could prove supportive to China's bond returns. Through this global recession and recovery, China's equities could continue to outperform other countries, as its domestic demand rebounds.

While China may lead the global recovery, geopolitical risks have increased significantly

With China drafting the national security legislation for Hong Kong, the US judges that Hong Kong has lost autonomy and should now be treated under US law the same as mainland China. Travel will be impacted in that Hong Kong citizens may now have to apply for visas to enter the US (on the same basis as Chinese citizens). In addition, the US has also said that it will remove Hong Kong's preferential trading status. China has threatened countermeasures against the US.

This latest deterioration in US-China relations is very concerning and creates significant uncertainties for investors – especially those considering making greater allocations to China or Hong Kong. As a result, even as China's markets have performed well this year, investors are likely to pause and wait for more clarity on how US-China relations will unfold.

If the US is now going to treat Hong Kong like any other large city in China, credit rating agencies may also need to change their assessments as Hong Kong's sovereign rating is above that of China. Equity index providers may also have to reconsider their classifications as Hong Kong is in the MSCI World Index (with Developed Markets) while China is in the Emerging Markets Index. Should Hong Kong be reclassified as an Emerging Market, just like Shanghai and Shenzhen, then a significant amount of capital in Hong Kong would have to leave.

China needs to capitalise on its "Belt and Road" initiative and domestic supply chains

With the deterioration in US-China relations it becomes increasingly important for China to capitalise on its longer-term trading-bloc initiative (i.e. 'the belt and road') and the strength of its supply-chains domestically and across Asia.

Looking beyond greater geopolitical risks, as China continues to liberalise its financial markets, and rebalance its economy more toward services, its risk adjusted equity investment returns should become more appealing to longer-term investors. With the benefit of on-going economic rebalancing, if China's equity market returns can become less business-cycle/output-gap centric, then longer-term returns can improve and more importantly volatility can fall.

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