PORTFOLIO INSIGHTS

Honing in on China: more about companies, less about the economy

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IN BRIEF

- China's economic revolution continues to be one of the defining stories of the 21st century.
- Opportunities in the Chinese equity market have however been more selective.
- Increasingly we believe that—even as the economy moderates, and rebalances—the possibilities for equity investors in China are becoming more attractive.
- An important part of this story is the increased accessibility of A-shares, which include a range of companies which typically have not been available in the offshore Chinese equity markets.
- The A-share market is broad and liquid, and offers diversification benefits. With the right analytical resources it is possible to meet objectives with a range of risk preferences, from growth to income. China already has the world's second largest stock market. International investors increasingly need to learn more about it.

INTRODUCTION

China's economic revolution continues to be one of the defining stories of the 21st century. In 2000, China's gross domestic product (GDP) per capita was less than USD 1,000. Recent estimates for 2018 are closer to USD 10,000, placing it ahead of India and Indonesia as well as countries it used to lag, such as Mexico and Brazil.

GDP per capita (USD)	China	Brazil	India	Indonesia	Mexico	Russia	Turkey
31/12/2000	959	3,779	463	870	7,016	1,906	4,219
31/12/2018 (full-year estimates)	9,633	9,127	2,016	3,789	9,614	10,950	8,716

Source: Central Intelligence Agency's The World FactBook, International Monetary Fund's World Economic Outlook for October 2018; World Bank's DataBank. Data reflect most recently available as of 31/12/18.

This economic transformation has improved the quality of life of several hundred million people and this is clearly something to celebrate.

Companies, companies and companies

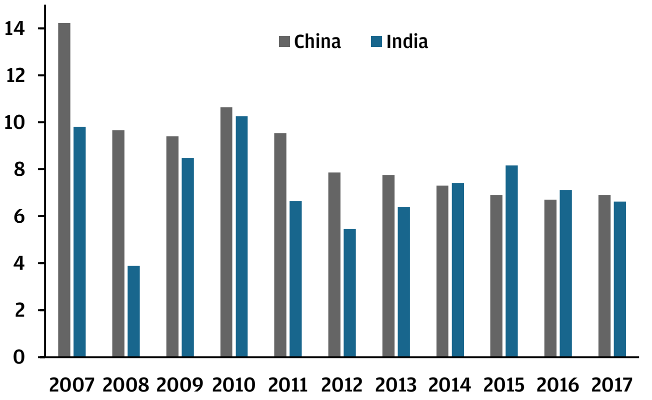
However, for foreign equity investors in Chinese stocks, the returns over the same period have been far less impressive. Conversely the gains in some stock markets elsewhere have been higher even if those countries have been unable to match China's development sprint.

For example, China and India have shared a relatively similar pace of economic growth, as can be seen in **Exhibit 1**, over the past decade despite India's much lower base. However, investors in India's equity market, as measured by the benchmark MSCI indices, have seen meaningfully higher returns, as shown in **Exhibit 2**.

China and India have shared a relatively similar pace of economic growth over the past decade despite India's much lower base

EXHIBIT 1: GDP GROWTH

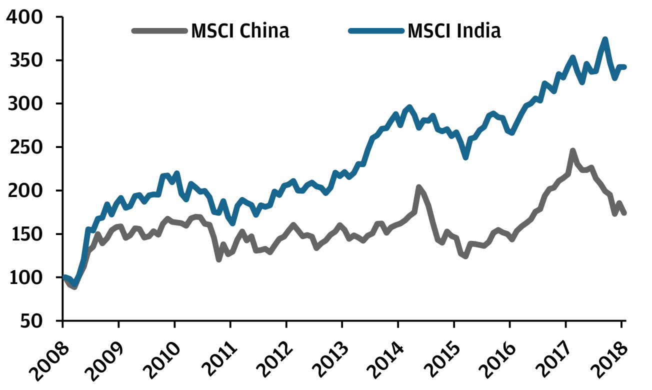
GDP GROWTH (ANNUAL Y/Y %)



Source: World Bank national accounts data and OECD National Accounts data files. Data reflect most recently available as of 31/12/18.

Indian equities have meaningfully outperformed Chinese equities despite the two economies sharing a relatively similar pace of economic growth

EXHIBIT 2: INDEX PERFORMANCE IN USD (REBASED END 2008 TO 100)



Source: Bloomberg. Data reflected most recently available as of 31/12/18.

This is a stark reminder that equity investors buy companies and not economies. High economic growth may create an environment that is conducive to higher revenue growth which in turn can contribute to increased earnings growth across the corporate sector—but this is not necessarily the case.

Nuances in index composition

In the case of China, much of the divergence between economic and stock market returns can be explained by the composition of equity indices. Many of the first major Chinese companies which listed overseas, as represented by the Hang Seng China Enterprise index (HSCEI), were state-owned enterprises (SOEs). Their primary focus was building out domestic Chinese infrastructure such as toll roads, power generation, telecommunications and energy. These were followed by the state-owned banks which now dominate the index, as illustrated in **Exhibit 3**.

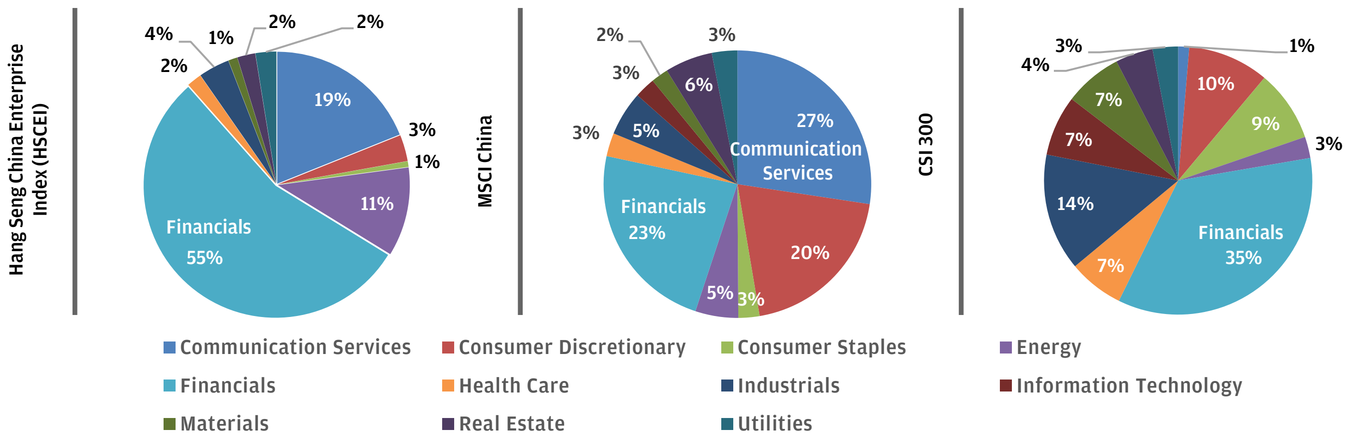
In essence, foreign capital was used to help fund domestic capacity expansion in industries whose hierarchy of stakeholders often did not place minority equity investors at the top of the list of priorities. Of course, disciplined and selective stock picking helped to mitigate this concern, but nevertheless the opportunity set was limited.

Conversely, while the Indian stock market has its own share of government-linked companies, it has been dominated by privately-owned companies whose "promoter" owner-managers are far more focused on share prices than often has been the case for China's SOEs.

More recently the emergence of China's internet giants has created a wider and more exciting set of opportunities, as seen in the MSCI China Index. MSCI now classifies these internet names under Communication Services and Consumer Discretionary. Nevertheless, MSCI China remains quite a narrow index, where information technology businesses and financials comprise fully 60%.

Part of the divergence between economic and stock market returns can be explained by the composition of equity indices

EXHIBIT 3: SECTOR DISTRIBUTION AMONG THE KEY INDICES

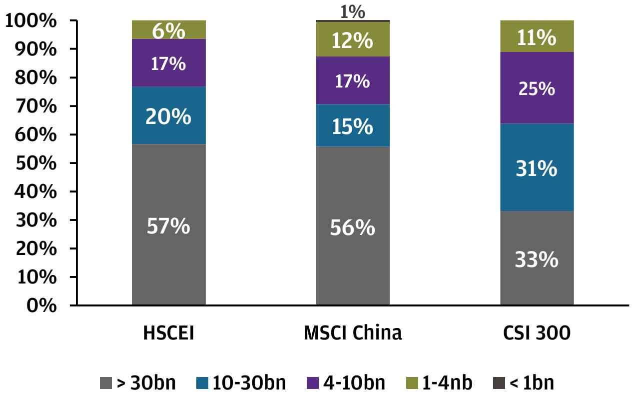


Source: Factset, MSCI, J.P. Morgan Asset Management. Data reflect most recently available as of 31/12/18.

The onshore A-share index (CSI300), offers a wider choice beyond information technology and financials, as illustrated in **Exhibit 3** above. The index also has greater exposure to mid- and small-cap companies, as seen in **Exhibit 4** below.

China on-shore markets offer greater exposure to mid- and small-cap companies

EXHIBIT 4: MARKET CAP BREAKDOWN (IN USD)



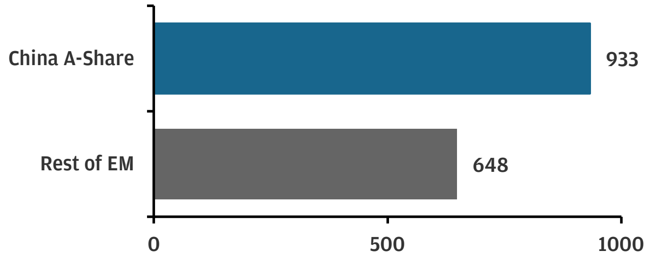
Source: Factset, MSCI, J.P. Morgan Asset Management. Data reflect most recently available as of 31/12/18.

Attractions of the A-share market

In this context, the A-share market has a number of attractive characteristics. First, it is both broad and liquid, offering a wide range of equities for investors. Indeed, as at the end of 2017 the A-share market contained more stocks which had over USD 10million of daily liquidity than all other emerging markets combined (**Exhibit 5**). Over 2018 there has been a marginal decline in value traded, but this remains a very liquid market.

The A-share market is both broad and liquid

EXHIBIT 5: NUMBER OF STOCKS WITH > USD 10MILLION LIQUIDITY



Source: J.P. Morgan Asset Management, Factset. Data reflect most recently available as of 31/12/17.

Second, the A-share market is diversified by sector. It offers investors access to some of the long-term trends which we find most exciting in China. The country's expanding middle class is both supporting and demanding an increasingly sophisticated set of consumer goods, for example in beverages and fashion. The power of domestic brands is increasing. Chinese companies are moving up the technology curve from lower margin commoditized goods to higher value areas such as handset components and software services. In some cases, China is pursuing its own business models, for example, in payment systems, areas of gaming and financial technology.

Third, the A-share market has low levels of correlation with offshore China equities as well as with other major asset classes globally (**Exhibit 6**). The market offers diversification benefits.

The A-share market has low levels of correlation with offshore China equities, as well as other major asset classes globally, offering diversification benefits

EXHIBIT 6: CORRELATION BETWEEN GLOBAL MARKET INDICES

CORRELATIONS OF MONTHLY RETURNS IN USD (31/12/2008 TO 31/12/2018)

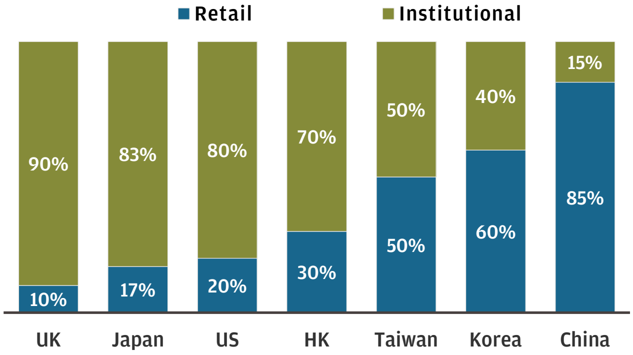
	CSI 300	MSCI China	MSCI Asia Pacific ex Japan	MSCI Emerging Markets	MSCI World	MSCI Europe	S&P 500
CSI 300	1.00	0.66	0.50	0.50	0.36	0.32	0.34
MSCI China	0.66	1.00	0.89	0.86	0.71	0.68	0.64
MSCI Asia Pacific ex Japan	0.50	0.89	1.00	0.98	0.96	0.83	0.78
MSCI Emerging Markets	0.50	0.86	0.98	1.00	0.73	0.72	0.64
MSCI World	0.36	0.71	0.96	0.73	1.00	0.94	0.97
MSCI Europe	0.32	0.68	0.83	0.72	0.94	1.00	0.85
S&P 500	0.34	0.64	0.78	0.64	0.97	0.85	1.00

Source: Bloomberg, J.P. Morgan Asset Management. Data reflect most recently available as of 31/12/18. The opinions and views expressed here are those held by the author at the date of publication which are subject to change and are not to be taken as or construed as investment advice. Past performance is not a reliable indicator of current and future results.

Fourth, the onshore Chinese equity market is dominated by retail investors, as shown in **Exhibit 7**. This contributes to the market's liquidity and volatility. Further, we believe that this investor demographic results in widespread pricing inefficiencies, which can be harnessed by market participants who keep a disciplined investment process and a longer term time horizon.

The A-share market is a retail-driven market with very low foreign ownership

EXHIBIT 7: BREAKDOWN OF TRANSACTION VOLUME ACROSS MARKETS



Source: Wind, UBS. Data is as of 2013 for Korea, 2014 for the UK and 2016 for the rest. All on transaction volume basis except for the U.S., which is on ownership basis.

Fifth, the A-share market now trades at more attractive valuations than has been the case for much of its history. There have been periods in which the A-share market traded at a substantial premium to offshore Chinese equities, and to other stock markets more generally. As can be seen in **Exhibit 8 and 9**, this is no longer the case, with the CSI 300 Index trading at a discount to its own history, and broadly in line with MSCI China. This normalization in valuation offers opportunity.

Offshore vs. Onshore China 12-Month forward price-to-earnings (P/E) valuations

EXHIBIT 8A: MSCI CHINA 12-MONTH FORWARD P/E

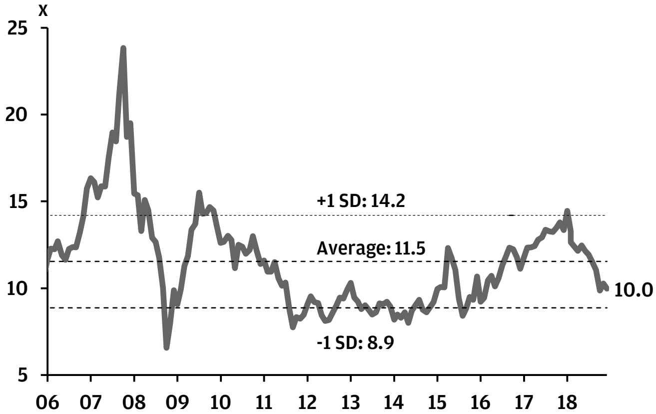
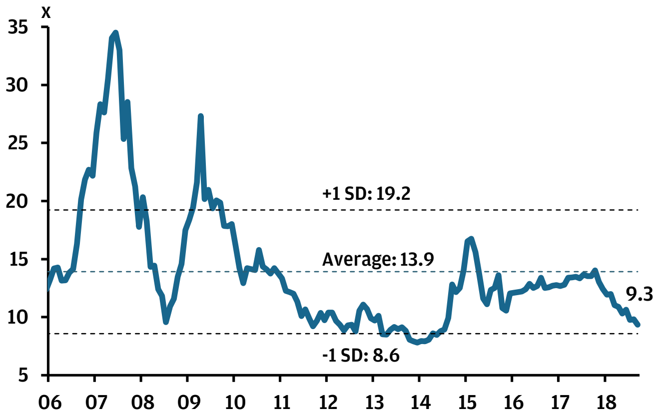


EXHIBIT 8B: CSI300 12-MONTH FORWARD P/E



Source: Bloomberg, Thomson Reuters Datastream. Data reflect most recently available as of 31/12/18. Indices do not include fees or operating expenses and are not available for actual investment. Past performance is not a reliable indicator of current and future performance.

Offshore vs. Onshore China trailing price-to-book (P/B) valuations

EXHIBIT 9A: MSCI CHINA 12-MONTH TRAILING P/B

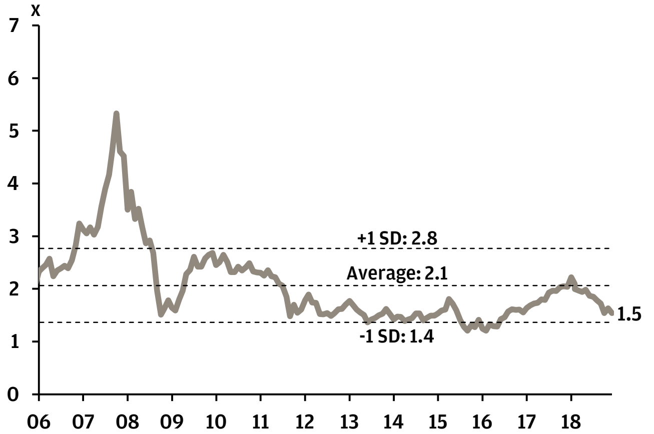
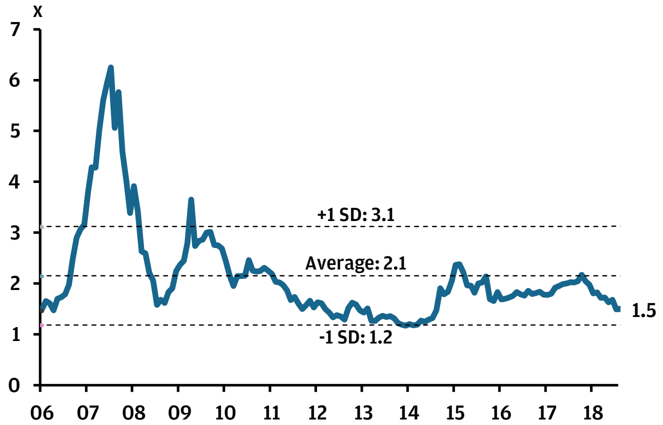


EXHIBIT 9B: CSI300 12-MONTH TRAILING P/B



Source: Bloomberg, Thomson Reuters Datastream. Data reflect most recently available as of 31/12/18. Indices do not include fees or operating expenses and are not available for actual investment. Past performance is not a reliable indicator of current and future performance.

MSCI's inclusion of A-shares

There has been much commentary that MSCI inclusion will lead to inflows of foreign capital into the A-share market. However, while increasing accessibility for A-shares should be positive for investor sentiment, the quality of those companies does not change with the indices that they are part of.

As active investors, we have been investing in A-shares for many years, prior to index inclusion, regardless of current or imminent index composition. We invested based on attractive fundamentals and the prospect of compelling long-term expected returns. For example, J.P. Morgan Asset Management's China Equity strategy, benchmarked to MSCI China, has been materially overweight China A-shares for several years, not in anticipation of greater index inclusion, but because we have found good investment opportunities in those companies.

The presence of a large but still relatively inefficient equity market is a more important factor for investors than index composition alone, particularly for global institutional investors who allocate holistically. The key is the increasing accessibility of A-shares. Much like investors in U.S. equities, who would typically focus on a company's fundamentals rather than on whether it's listed on the Nasdaq versus the New York Stock Exchange, we believe international investors accessing China will become increasingly agnostic on the mechanisms as access options evolve.

We have seen a meaningful uptick in interest from institutional investors in Asia, Europe and increasingly the U.S., who are seeking greater context on A-shares as they consider China's weighting in long-term portfolios.

Improving market access

As set out above, the opening of the A-share market is resulting in improved access to higher-quality companies that already exist in China, rather than the creation of such companies. Our belief is that the government sees increased international involvement as one way of encouraging improved institutional structures in China's investment industry, and the deepening of its financial sector reforms. Over time this should help to lengthen investment horizons and reduce market volatility as retail participation diminishes as a percentage of the whole.

The routes by which foreigners can access A-shares currently include the Qualified Foreign Institutional Investor, Stock Connect and participatory notes programs. We believe it is appropriate to use a combination of all three. Further, with the right analytical resources it is possible for investors to uncover investment opportunities with a range of risk preferences, from growth to income. There are various ways to participate in a market of this breadth and depth, as we illustrate in the following page.

There are various ways to participate in a market of such breadth and depth: both Growth and Income

EXHIBIT 10: HOW SHOULD INVESTORS POSITION THEMSELVES IN CHINA?

Attractions of both Growth and Income styles

Growth-focused

- **Long-term capital appreciation**
- **Higher upside capture**

+

Income-focused

- **Long-term income stream**
- **Low volatility + Better downside protection**

Source: J.P. Morgan Asset Management.

The speed bumps...

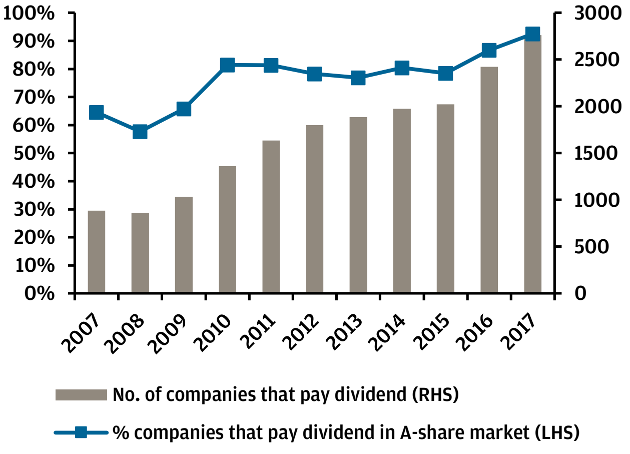
No path is bump free. At a stock level, corporate governance in China remains an area for scrutiny and selectivity. Although misapplication of the stock suspension framework had been an issue in the past, the China Securities and Regulatory Commission has taken steps to tackle use of suspensions and disclosure around them.

An increase in the number of companies that pay dividends has been positive, but certainly payout ratios have room to grow, as shown in **Exhibits 11 and 12**.

Transparency and capital allocation discipline remain uneven although they have improved over time. We use fundamental research to identify potential issues, to monitor change and to help select management teams who we believe have the capacity to perform well over the longer term.

More Chinese companies have started to pay out dividends

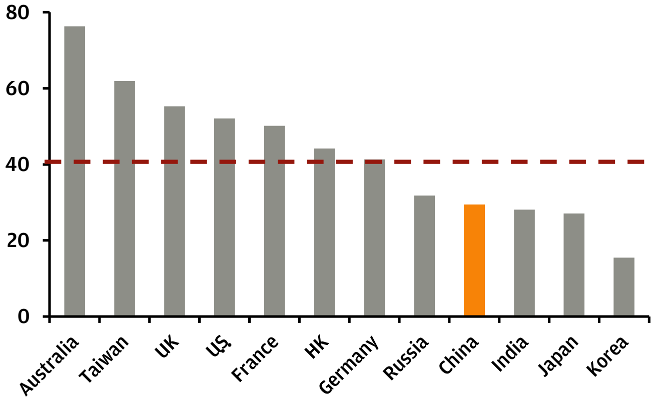
EXHIBIT 11: DIVIDEND PAYING COMPANIES IN THE A-SHARE MARKET



Source: Hai tong Securities. Data reflect most recently available as of 31/12/18.

Dividend payout still has room to improve

EXHIBIT 12: PAYOUT RATIO ACROSS MARKETS (%)



Source: Hai tong Securities. Data reflect most recently available as of 31/12/18.

... and headwinds

Macro headwinds for A-share equities include geopolitical friction such as trade concerns, and the challenges of multi-year efforts to rebalance the domestic economy. These macro concerns are fluid.

On China's trade dispute with the U.S., our base case remains that a trade war would be in no-one's best interests, not least American consumers. Their real incomes will decline should tariffs and/or a broad relocation of manufacturing to more expensive locations result in higher prices for consumer goods. Any route to resolution is likely to involve volatility along the way.

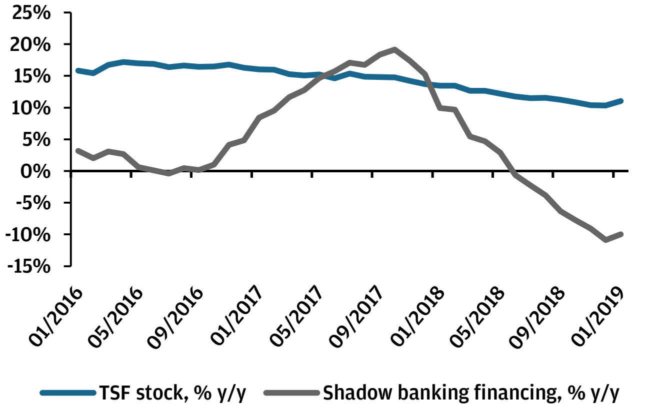
That aside, there are a number of ways to play structural themes which are generally oriented around longer term domestic growth stories. Examples include structural winners in the consumer (such as liquor and the growing domestic travel industry), healthcare and technology sectors. There are many alternatives to the commoditized low-margin export sectors which are most vulnerable to tariffs.

A hurdle within the Chinese economy involves the pursuit of longer term, sustainable rebalancing whilst adjusting fiscal and monetary policy in response to internal and external events. For example, the deleveraging process which necessarily resulted in a contraction in the shadow banking sector, also caused unwelcome shifts in bank loan books from the private to the public sector. The government has achieved success in some areas such as consolidation of the steel and aluminum industries, but there have been missteps and micromanagement in others.

We feel the longer term course as set out in late 2017 at the 19th Communist Party of China National Congress is positive: towards a more balanced and sustainable future for China, in economic, environmental and social terms. The Chinese government's success in managing its economy over the past generation should not be taken lightly.

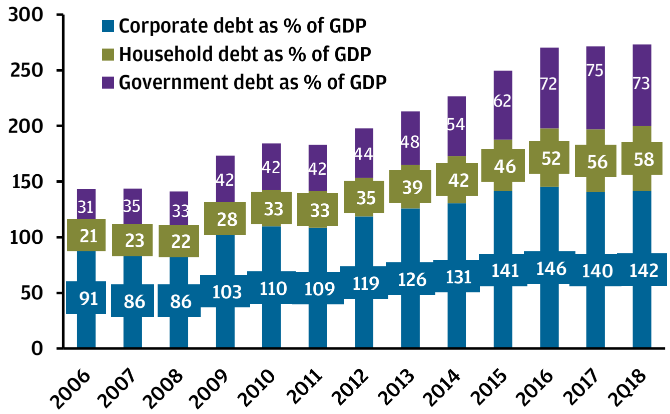
Policy-driven Deleveraging - achievements so far

EXHIBIT 13A: SLOWING CREDIT GROWTH IS DRIVEN BY SHRINKAGE OF SHADOW BANKING CREDIT…



Source: People's Bank Of China. Data reflect most recently available as of 31/12/18. TSF = Total Social Financing.

EXHIBIT 13B: … LEADING TO A STABILIZED DEBT/GDP



Source: Bank for International Settlements. Data reflect most recently available as of 31/12/18.

Conclusion

Over the past two decades, China's economic growth has been astounding, but its aggregate stock market returns have been less impressive. One of the key reasons for this has been the composition of the listed sector, which for offshore investors has been dominated by SOEs.

Even as China's economy rebalances and slows from previous breakneck rates, the opening up of the A-share market offers offshore investors the chance to invest in higher-quality companies in structurally-attractive areas such as consumption, healthcare, technology and automation. The A-share market is broad and liquid, while offering diversification benefits when compared with other stock markets.

This is not to say that investing in A-shares is risk-free. The Chinese authorities have done a very robust job in the past of navigating macro challenges, but headwinds persist. Governance is improving but it remains uneven. The case for active management is strong. Investment teams with the right resources, and with an appropriately robust long-term analytical discipline, have a good opportunity to take advantage of the pricing inefficiencies in what remains a retail-driven market.

The inclusion of A-shares in the MSCI indices, and in Financial Times Stock Exchange Russell starting from June 2019, is significant as it increases visibility for an asset class that already contains many attractive equities. China has the world's second largest stock market: whichever benchmarks international investors use, they increasingly will have to pay more attention to A-shares. The time to learn more is now.

J.P.Morgan
Asset Management