

# Three reasons to consider allocating to Chinese A-shares



Despite being one of the largest and fastest growing economies in the world, we believe investors do not have enough exposure to Chinese equities, in particular onshore Chinese equities.

We've found that the average international investor's total China exposure is 4.6% of its total assets<sup>1</sup>. A large part of this is likely to be in offshore Chinese equities through emerging market (EM) equity strategies benchmarked to the MSCI EM Index. While China accounts for around 34% of the MSCI EM Index, the weight of onshore Chinese equities (China A-shares) is only about 5%.

However, judging from prior examples of Taiwan and Korea, we expect that onshore Chinese equities will continue to rise in global indices.

## 1. We see onshore Chinese equities delivering high single digit annual returns over the next 10 to 15 years

In our 2023 LTCMA, we lifted our forecasts from 6.6% to 9.5% in local currency and from 8.2% (6.9% in Euro) to 11.8% (9.7%) in US dollar terms<sup>2</sup>. These are generally higher than both our emerging and developed market equity returns assumptions.

We maintain last year's adjustments to reflect the improving sectoral mix of China's equity market towards technology and consumer sectors, with higher margins. But this boost is offset by a valuation penalty, given ongoing risks of regulation in the country's corporate space. Currency is also a notable tailwind this year, particularly in USD terms.

Among the key factors that could further affect our long-term assumptions for Chinese assets are: the pace of structural reforms; policies seeking to rebalance efficiency and equality in the economy; liquidity; and the external environment.

## 2. Onshore Chinese equities offer clear diversification benefits

Chinese onshore equities have historically had a low correlation to other assets, offering investors potentially attractive portfolio diversification opportunities. Correlations will likely rise as foreign investor participation in the Chinese market rises however, we believe correlations will remain low relative to developed market assets, given China's distinct economic and policy cycles. With Chinese growth likely to accelerate into 2023, we think China could once again diverge from the global business cycle.

Many investors do not differentiate between offshore (Hong Kong-listed H-shares and US-listed ADRs<sup>3</sup>) which are more correlated to global markets and onshore A-shares. 2021 was a stark reminder that these markets can diverge. Offshore equities were hit by concerns over forced delisting of ADRs – onshore equities rarely have ADRs – and regulatory change that primarily impacted mega-cap offshore stocks. In contrast, onshore equities delivered positive returns, albeit more muted than global equities, as China tapered its stimulus. Then in the final quarter of 2022, onshore China lagged MSCI China by close to 10% as offshore equities responded more positively to policy support for the real-estate and tech sectors, and the prospect of an end to zero-Covid.

<sup>1</sup> Source: J.P. Morgan Asset Management; CEIC, People's Bank of China, Shanghai Stock Exchange, Shenzhen Stock Exchange Guide to China. Data are as of January 31, 2023.

<sup>2</sup> Forecasts are not a reliable indicator of future performance.

<sup>3</sup> American deposit receipts are shares of foreign companies listed on US stock exchange.

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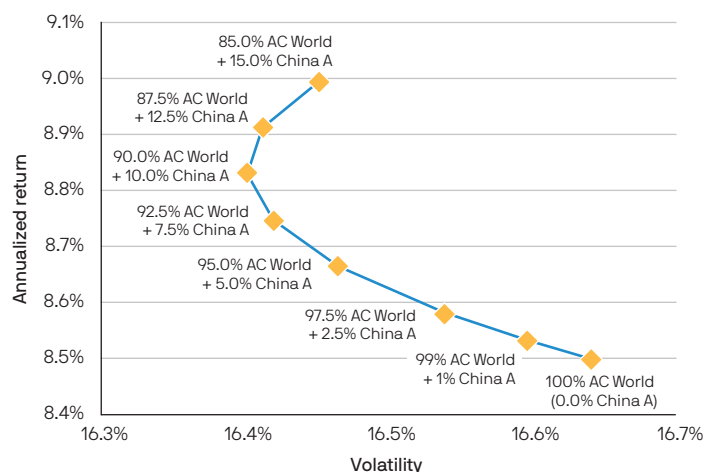
## Exhibit 1: China A shares offer investors diversification opportunities

### Correlations between A-shares and global equities

	S&P 500	MSCI ACWI	MSCI EM	MSCI EAFE	MSCI China	CSI 300
S&P 500	1.00					
MSCI ACWI	0.98	1.00				
MSCI EM	0.76	0.83	1.00			
MSCI EAFE	0.89	0.94	0.87	1.00		
MSCI China	0.54	0.62	0.85	0.67	1.00	
CSI 300	0.40	0.45	0.59	0.44	0.72	1.00

### Efficient frontier

MSCI All Country World and China A-shares



Source: MSCI, J.P. Morgan Asset Management; (Left) FactSet, China Securities Index, Standard & Poor's. Correlations are based on monthly price return data in U.S. dollar terms for the period 01/31/2008–1/31/2023. The efficient frontier returns and volatility are based on the J.P. Morgan 2023 Long-term Capital Market Assumptions (LTCMA) estimates. Guide to China. Data are as of January 31, 2023.

We modelled Chinese equities' return projections, their correlation to other markets and volatility risk based on historical data. A dedicated allocation to A-shares of up to 10% over and above current benchmark index weights would result in a more optimised portfolio with an improved efficient frontier — which means A-share investors can expect higher returns for each given level of additional risk. Put another way, with global equity correlations high, not having adequate onshore exposure may represent an opportunity cost in terms of portfolio diversification\*.

### 3. Onshore equities provide exposure to China's increasingly consumer-led economy

China's equity market is shifting towards sectors that are benefiting from its transition to a more consumption and innovation driven economy, and away from sectors that are more reliant on investment and exports. The beneficiaries of China's economic transformation include consumer goods, technology, health care and high end manufacturing. We expect these shifts to continue, potentially offering China A-share investors more exposure to these high growth sectors compared to emerging markets overall.

The MSCI China A Index also gives considerably greater exposure to small and mid-cap stocks that typically service the domestic economy, with over 20% of companies under \$5 billion market cap compared with less than 10% for MSCI China and MSCI EM. That has meant they are more sheltered from US-China tensions, and less subject to Chinese regulatory interventions which have targeted mega-cap companies that are generally listed offshore.

\* Diversification does not guarantee positive returns and does not eliminate the risk of loss.

### Conclusion

There are significant investment opportunities in the onshore market in China and increasingly more ways to access them. The **JPM China A Research Enhanced Index Equity (ESG) ETF (JREC)\*** provides exposure to onshore Chinese equities by exploiting stock specific insights with index like characteristics and robust risk management. As we will explore in our next paper, 'Benefits of China A-Shares for active ETF investors', A-shares are deep, liquid, and inefficient market and therefore a fertile environment for well-resourced managers equipped to manage environmental, social and governance (ESG) risks among other things.

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