Sumitomo Mitsui DS Asset Management

White Paper

Managing China exposure: the case for China A Shares

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Foreword

SEIZING OPPORTUNITIES IN CHINA'S POST-COVID RECOVERY: FOR ACTIVE STOCK SELECTORS, THERE IS CAUSE FOR SOME OPTIMISM DESPITE POLITICAL AND ECONOMIC UNCERTAINTIES

In March, Sumitomo Mitsui DS Asset Management hosted an investor briefing to discuss new investment opportunities in China. In essence, we believe we shouldn't be too enthusiastic about China, even though it is early-stage recovery, but not too pessimistic either, even though there are still many potential structural issues."

In 2023, China's fiscal policy will be pro-growth without massive fiscal stimulus, with the government expressing an emphasis on economic recovery. But the government will continue to focus on high-quality growth because it wants to transform China from a low-income to a high-income economy.

Xi Jinping's consolidation of power is perceived as a key risk by Western investors. On the other hand, it has enabled quick political action to be taken; for example, switching from its zero-Covid policy in Nov/Dec 2022, and the government focus shifting to growth and economic capacity.

Although China's growth rate fell to 3% in 2022, due to its zero-Covid policy, it is expected to recover above 5% this year due to strong policy support.

With these factors combined, now is a good time for stock selection in China

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Naoto NAGAI
Chief Investment Officer at Sumitomo Mitsui DS Asset Management

Introduction

A Shares – the future of China's economy

China has been one of the biggest economic and investment stories of the 21st century, but Covid-19 dealt a significant blow to China. In the wake of the pandemic, however, the country is seeking not merely to return to growth but to embark on a new era of economic development.

China's earlier phase of rapid expansion was built on labour-intensive manufacturing and exports. The next step is towards upgrading its manufacturing base to higher technology and growing its services sector. China's leadership is increasingly focusing it economic strategy on the domestic economy and its burgeoning middle-class – on what some might call the country's 'real economy.'

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Domestic markets are opening to overseas investment and accessing China’s domestic economy can provide valuable diversification from markets in the US and Europe. There is an opportunity to invest directly in this next stage of the country’s economic development through China A shares – equities traded in local currency on mainland stock markets.

Rebalance and renewal

China's economic growth was dealt a severe blow by the Covid-19 pandemic. As well as shutting down much economic activity, the global slowdown took its toll on China's exports and exposed the risks to international business from overdependence on long supply chains.

The lifting of China's zero-Covid policy will lead to a renewed growth, however. This may not be immediately apparent as the reversal of lockdowns is likely to lead to some fresh outbreaks of Covid. However, by the second quarter of 2023, we expect growth to be well underway which should be an attractive prospect for international investors. But even more significant is the changing focus of China's economy.

At its Central Economic Work Conference in December 2022, The Communist Party of China (CPC) outlined a pro-growth plan of fiscal expansion and a mild monetary policy for the year ahead. It also identified five key issues *(1) for particular focus:

- Expanding domestic demand.
- Accelerating construction and modernising of manufacturing.
- Equal treatment for private and state-owned businesses.
- Attracting foreign capital.
- Improved management of economic and financial risks.

The strategic objectives of these stated policies are clear – to reduce China's dependence on exports, to develop the country's asset-base in industry, and to develop its domestic consumer economy.

Central pillars of industrial policy will be to increase the capability of manufacturing with technology, including robotics. We are also likely to see a drive to fill gaps in domestic supply chains that may have previously been weak links in China's industrial sector. Manufacturing more components, such as integrated circuits, onshore is expected to be a key feature of this strategy.

China's state media has reported a future focus on peak carbon and eventual carbon neutrality. From that, energy investment, including the manufacturing of solar and other renewable technologies, will be a feature of the new strategy.

China's consumer economy has been roiled by an overheating of the property market, to which the focus on managing financial risk is clearly aimed. Digital platforms were identified by the CPC as part of its strategy for expanding domestic consumer demand.

The significance of this new economic strategy should not be underestimated. Nor should the ability of China's centralised one-party state to execute that strategy. The objective is simple – to rebalance economic growth in China.

These developments are reflected in our forecasts for the Chinese economy in 2023 and 2024. We have already mentioned our expectations that real GDP growth for 2023 will be 5.3% and we expect this to continue with a growth rate of 5.2% in 2024 *(2).

We expect the contribution of exports to GDP to decline slightly this year and next (down 0.5% and 0.3% respectively). However, we expect investment to increase 4.5% this year and 4.3% in 2024 *(3). Most importantly, we forecast consumption to rise by 7.5% this year and by 7% in 2024 *(4).

The story of China's economy over the last two decades is a familiar one – labour-intensive, manufacturing and exports. That story is changing, and it is time to rethink the investment opportunity of China.

Figure 1: China GDP Contributions *(5)

	2021	2022	2023 (F)	2024 (F)
Real GDP(%)	8.4	3	5.3	5.2
Consumption	10	1.9	7.5	7
Investments	2.7	3.8	4.5	4.3
Net Exports(contribution)	1.7	0.5	-0.5	-0.3

*Note:
(1) Source: Xinhua News Agency
(2) (3) (4) (5) SMDAM. China Macro Economy and Equity Market Outlook for Q1 2023

(F)= Forecast

Share types

International investors are typically most familiar with accessing China equities either through H Shares or through American Depositary Receipts (ADRs). These types of equities have their value and uses in a global portfolio, but they do not provide a pure and unmediated link to the domestic Chinese economy.

H Shares

H Shares are equities in mainland Chinese companies traded on the Hong Kong stock exchange and denominated in Hong Kong dollars. There are more than 300 companies with H shares , typically traditional and established groups such as Ping An and Great Wall Motor.

American Depositary Receipts.

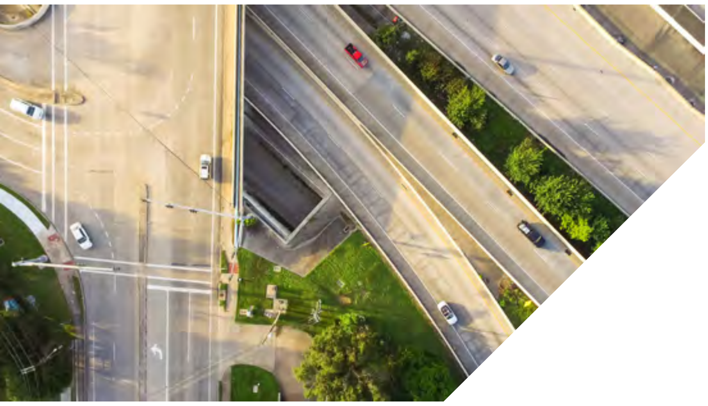
There are about 160 Chinese groups with ADRs traded on either the Nasdaq or the New York Stock Exchange. Among these ADRs are some of the largest cap Chinese groups including Baidu and Alibaba. ADRs are, naturally, traded in US dollars.

The trading currencies of both H shares and ADRs mean they do not trade in lock step with the underlying equities of these companies. Currency fluctuations can play a significant role in their price movements.

Both H shares and ADRs are more influenced by investor sentiment, which itself can be driven by factors outside the performance of the underlying companies, including market perceptions of geopolitical events and uneven supply and demand in these secondary equities. In the case of ADRs, US investment trends and market sentiment also add noise to the prices on the New York Stock Exchange (NYSE) and Nasdaq.

A Shares

A Shares are the equities in Chinese companies, traded on the Shanghai and Shenzhen stock exchanges and denominated in Renminbi. Shanghai represents the more traditional industries while Shenzhen reflects the younger and often technology-driven sectors of the economy. They represent the vast bulk of equity value in Chinese companies. As such, they are less influenced by external factors. Trade in A shares can be carried out with a much greater focus on business fundamentals. Historic restrictions on access to A shares for overseas investors means they are overwhelmingly held by domestic Chinese investors, including a sizeable and active retail market.



A shares represent a far more fundamental exposure to the Chinese economy than H shares and ADRs. Correlation between A shares and other global markets, such as the US, is extremely low. Furthermore, A shares have typically traded at a premium to H shares in the same company. Historically, that premium has averaged about 20%.

A red carpet for overseas capitalists

The renewed economic strategy outlined by China's leadership comes hand in hand with a recognition that private business and foreign investment will play an essential role in rebalancing the economy.

This rebalancing has been underway for some years already. The opening of China's domestic mainland stock markets in Shanghai and Shenzhen to overseas investors began in 2002 with the launch of the Qualified Foreign Institutional Investor programme, which gave leading institutions direct access to A shares. The initiative was extended in 2011 with the Renminbi Qualified Foreign Institutional Investor (RQFII) programme. The scheme, however, set tight quotas on access.

In 2014, the launch of Stock Connect provided wider access to mainland exchanges and equities, and this is now the leading route to access A Shares.

Further relaxation of access for foreign investors is now planned. Following the China's Central Economic Work Conference in December, the country's State Council stated:

"The country will make greater efforts to attract and utilize foreign capital, widen market access, promote the opening-up of modern service industries, and grant foreign-funded enterprises national treatment..."

The A shares opportunity

We have established that the Chinese economy is undergoing a renewal – a return to higher headline growth coupled with a fresh focus on its industrial sophistication and its domestic consumers. Furthermore, exposure to this new dimension of Chinese growth is best achieved through direct access to its mainland stock exchanges through A Shares. However, there is another aspect to the appeal of A Shares.

Diversification and decoupling

China is at a different stage in the business cycle from much of the world and with its economic growth driven by investment in a domestic market, it offers an extremely valuable diversification for investment portfolios, which might otherwise be dominated by US or other developed economy equity markets.

A Shares already have an extremely low correlation with other leading markets, and this is likely to remain the case for the foreseeable future.

China's alleged 'decoupling' from the rest of the world is an important aspect of this potential diversification. In one sense, the case for decoupling can be overstated. Despite worsening relations between the US and China in recent months, and several years of US policy designed to reduce dependency on China, the bilateral trade in goods between the two economies hit a record high of US$691 billion in 2022. Notably, China's goods exports to the US rose by US$32 billion. As we have noted, China's economic strategy is now turning more domestic, and our forecasts include the expectation that exports will contribute less to GDP going forward. However, 'decoupling' does not pose a serious threat to the overall economy of China.

In another sense, decoupling is taking place in precisely the terms we have outlined. The turn towards domestic investment, an upgrading of its industrial base and a focus on domestic consumption will mean that China's economy will not move in lockstep with the rest of the world.

To the degree that China is decoupling from developed markets, it represents an opportunity to diversify risk away from those developed economies.

Currency

Currency risk is naturally an essential issue for international investors and the prospect of increasing exposure to Renminbi might raise concerns. The outlook for exchange rates, however, strengthens rather than weakens the case for A shares.

The robust growth expected from the Chinese economy over the next two years will underpin the Yuan and maintain its stability against the US dollar. Chinese authorities have made little secret of their ultimate desire for the Yuan to be regarded as reserve currency and central policy is extremely unlikely to take any steps that might undermine that possibility.

Currency factors cannot be ignored, but the fundamentals of many A shares outweigh this risk.

Index re-weighting

MSCI has taken a cautious staged approach to its inclusion of A shares in its global index. The process began in 2018, when China A Share companies were given a 5% weighting of their full market capitalisation in MSCI investible indices. During 2019, that weighting was increased first to 10% then to 15% and now stands at 20%, partly in response to the increased access to A shares through the Stock Connect initiative.

The increased weighting given to A shares in the MSCI Indices is itself an incentive to global capital to consider direct investment in the Shanghai and Shenzhen exchanges. The direction of travel is clear and in the medium to long term we should only expect that inclusion rate to rise.

The opportunity for active management

For many years, investment in China's equity market has been driven significantly by macro-economic and geopolitical considerations. Greater access to A shares and their role as a cornerstone of the domestic Chinese economy means this approach is no longer appropriate. With greater access to a wider range of shares, fundamental company analysis is essential and is also the key to returns.

The opportunity is considerable. The reshaping of the domestic economy and the drive for growth in new areas offers the chance to bring active portfolio management and analysis to bear on the companies at the heart of the Chinese domestic economy. A broad-brush approach will miss the most valuable opportunities. Expertise and close analysis on the ground in China will be vital for investors looking to take advantage of the trends we have been describing.

More than three quarters of the value of the Shanghai and Shenzhen markets are held by China's huge retail investor community. With such a high retail investor stake in A Shares, price formation is not as efficient as in markets where professional or institutional investors dominate. This creates further opportunities for professional investors to bring fundamental analysis to bear and identify unrecognised value.

ESG

The ESG challenge in China cannot be ignored. Aside from widespread international concerns over some corporate activities inside China's borders, the country's economic miracle of the last few decades has been dominated by high carbon emitting industries and a rapid expansion of fossil fuel energy supply. Times are changing. As already noted, the country's leadership has identified that a push to carbon neutrality should be part of its economic strategy, and investment and support for renewables and other low-carbon or carbon-reduction businesses is likely to be a feature of public policy. Solar energy groups and companies linked to the development and production of electric vehicles are all represented among China A share companies. This provides an opportunity to invest in growth businesses that contribute to a positive ESG profile.

As with portfolio selection, the key for overseas investors will be analysis and engagement. The government's stated objective of increasing foreign investment in China will be a chance for international investors to bring international standards and scrutiny to bear on domestic Chinese businesses. It will, of course, be in the interest of Chinese businesses to match that engagement with an active ESG agenda of their own.
The ESG challenges cannot be glossed over. But the same approach applied in developed economies to ESG will also apply in China A shares – engagement should and will always be a superior strategy to divestment.

Time to invest in the real Chinese economy

The remarkable emergence of China as a leading global economy has been one of the most significant developments of the last thirty or more years.

For investors, the role China has played in their investment strategies has been focused on headline GDP growth rates, export capacity and the role of China in helping maintain low inflation rates across the globe. A handful of major groups, such as Alibaba or Baidu have caught the attention of international investors.

And for most of the recent past, access to other equity opportunities in China have been restricted.

The new China story is built on that past but is also significantly different. Domestic consumption, digital consumer platforms, upgraded manufacturing using new technology, and a rising services sector are the forces that will shape the Chinese economy in the years to come.

With this development, investors' focus should turn from that broad brush view and look at the opportunities to invest in the fundamentals of Chinese companies that are at the heart of this future and whose value is held in A Shares.

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Asian expert, global reach.

Sumitomo Mtisui DS Asset Management is one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

Philosophy

As a professional asset management company, we incorporate new investment techniques in response to changes in the market environment and provide top-tier investment performance that aims to produce steady earnings in the medium and long term. For active investment products, we secure excess earnings by defining inefficiencies in the market and constructing a consistent investment process to turn these inefficiencies into investment opportunities.

In order to achieve this, we uncover inefficiencies through our unique global research platform, take appropriate risks based on our professional skill, manage risks from diverse perspectives, and conduct constant quality control throughout the entire investment process.

Capabilities

Our investment solutions span Japan and Asia equities, fixed income, multi asset, REITs (Real Estate Investment Trusts) and others. Our investment expertise is leveraged off our industry-leading research platform and global network. We incorporate new investment techniques in response to an evolving market environment to provide top-tier performance that aims to deliver strong medium and long-term returns.

Our experts

Naoto Nagai

Chief Investment Officer Asia

Wei (Maggie) Sun

Stock Recommendation

Toshiyuki Murai

Product Specialist

Contact Us

Sumitomo Mitsui DS Asset Management Company, Limited

Toranomon Hills Business Tower 26F, 1-17-1
Toranomon, Minato-ku, Tokyo 105-6426, Japan

E-mail: intl_mktg@smd-am.co.jp