

2019

**Global Market
Outlook**

Not Over
Until It's Over

Investment Theme

All Eyes on China

Short-term risks but long-term investment opportunities in China.

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Following an exceptionally strong 2017, China had a tough 2018 due to escalating trade tensions with the US and fears of a broader stand-off between the world's two largest economies. In 2019, we think security selection will be key as US-China relations fundamentally shift and the risk of a policy mistake increases. Longer term, China's consumer growth story should remain intact, provided that the US and China can resolve their differences and avoid a multi-year impasse. If relations start to improve, investors may wish to capitalize on the bad news already priced in to Chinese stocks. Moreover, given the index changes due to occur in 2019 and market inefficiencies, investors may wish to consider a stand-alone active Chinese equity allocation that allows them to fine-tune their exposure, especially if risks escalate.

Shift in US-China Relations

Beyond the implementation of tit-for-tat trade tariffs, we are witnessing a shift in the US-China relationship from “constructive engagement” (applied by the last three US presidents) to “strategic containment.” This reflects the US view that China has not played by the rules of open-market economies despite being in the World Trade Organization since 2001. While China has taken steps to open up its markets, it has not done enough to avoid the suspicion that its mainly state-owned enterprises enjoy advantages over private companies elsewhere.

Its plans to dominate the industries of the 21st century—Made in China 2025—as well as recent military moves in the South China Sea have alarmed not only the Trump administration but other national security experts as well. This suggests to us that this strategic shift might last beyond the Trump years, and while markets seem to have priced in the worst expectations around tariffs, investors are still absorbing the implications of this sea change in relations.

Weak Investor Sentiment

China has already taken some measures to counter the effects of the trade war on growth, but these have not prevented the impact being felt in China and around the world. Investor sentiment toward the country soured in 2018 amid concern that the government might not be able to deal with both a trade war and de-leveraging simultaneously without a hit to growth. Our active quantitative and fundamental equity teams are currently underweight China in their emerging market (EM) portfolios, while our multi-asset team has a small underweight to EM. China will therefore have to convince investors that it can stay on a path toward orderly deceleration while avoiding a hard landing. The IMF has reduced its 2019 forecasts for global, US and Chinese growth, specifically citing trade tensions as the reason and calling for de-escalation.

Despite expectations that growth will slow, in our base-case scenario China is expected to grow 6.5% in 2018 and around 6% in 2019. This compares favorably with an average of 2.4% for advanced economies in 2018 and 2.2% in 2019. Meanwhile, the economy continues to rebalance toward domestic consumption and services-oriented sectors as China continues on its path of economic reform and opening up.

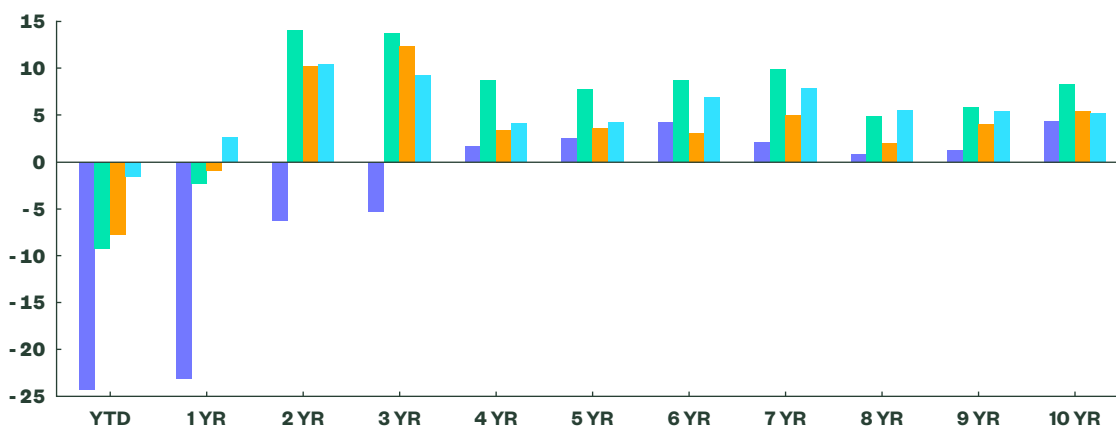
Stock Selection Key in 2019

Following the sell-off in 2018, equity valuations across China have become much more attractive, with a forward price-to-earnings of 11x for the MSCI China Index, versus a historical average of 12x and developed market equities forward price-to-earnings of roughly 16x. While some may argue that these stocks are cheap for a reason, we think certain sectors look worth investigating within a framework of active management. Our active fundamental EM team is underweight IT, communications services, materials, industrials and real estate, but overweight consumer discretionary stocks, amid rising wealth in China and higher disposable incomes. The team also has small overweights to energy and healthcare.

From a value perspective, Chinese bank valuations are near rock bottom levels with price-to-book of well under 1x and a yield around 5%, limiting further downside. Moreover, EM earnings growth is likely to revert above that of DM as the impact of US fiscal measures dissipates. If the US and China can reach a settlement, the darkest cloud overshadowing global equity markets would lift, and Chinese equities would be among the biggest winners. China has tended to outperform most other emerging and developed markets in the last decade (see Figure 1).

Figure 1
**China Outperforms
Over the Long Term**
Benchmark returns in USD,
as of September 29, 2018

■ MSCI China A-Share
■ MSCI China
■ MSCI Emerging Markets
■ MSCI World ex USA



Benchmark Name	YTD	1 YR	2 YR	3 YR	4 YR	5 YR	6 YR	7 YR	8 YR	9 YR	10 YR
MSCI China A-Share	(24.16)	(22.99)	(6.14)	(5.25)	1.67	2.58	4.21	2.22	0.80	1.28	4.42
MSCI China	(9.12)	(2.20)	14.07	13.69	8.69	7.85	8.65	9.88	4.93	5.88	8.26
MSCI Emerging Markets	(7.68)	(0.81)	10.22	12.36	3.44	3.62	3.17	5.03	2.12	3.99	5.40
MSCI World ex USA	(1.50)	2.67	10.42	9.31	4.09	4.25	6.93	7.88	5.59	5.43	5.18

Chinese Bonds Offer Higher Yield with Shorter Duration

Chinese government bonds, meanwhile, have yielded about 3.6% on average with duration of 6.5 years compared to 1.5% yield and 7.9 years of duration for the existing global treasury universe.¹ Given its small foreign investor base, the Chinese bond market has a very low correlation with global bond markets, for example, they have a correlation of just 0.2 versus US Treasuries. While this correlation may increase as foreign ownership of domestic Chinese bonds rises, it should remain low enough to offer good diversification benefits for global investors.

¹ Bloomberg Barclays Point analytics

Consider Standalone Allocation to China Amid Index Changes

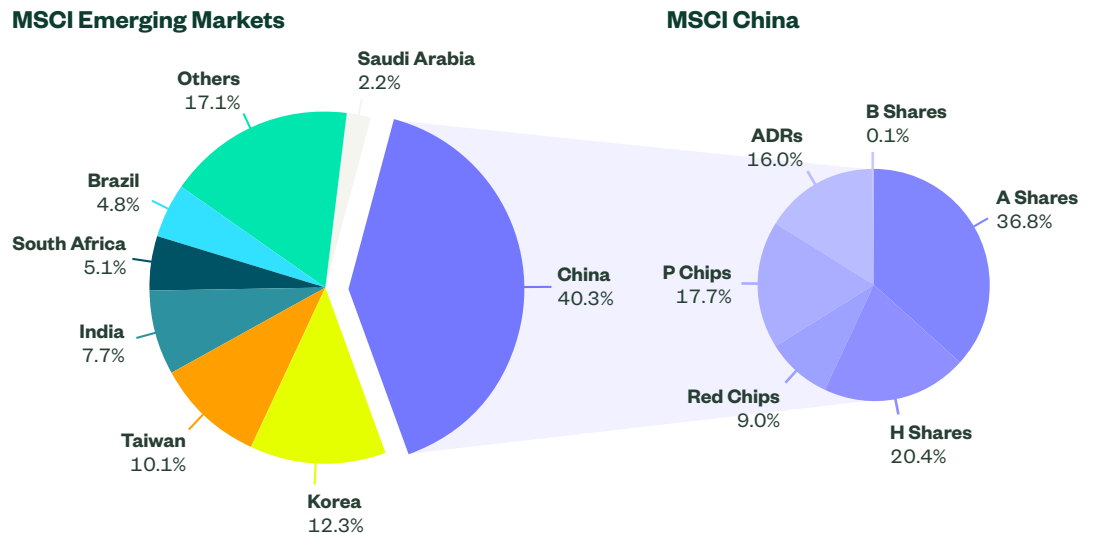
China remains one of the biggest underweights among EM investors, but has been swift to respond to the requirements of major emerging market equity and debt indices that wish to include, or that are considering including, onshore Chinese securities in a phased approach from 2019.

These potential changes could have significant effects on index composition and investor allocations. Given the risks and opportunities facing China in 2019, we think now is the time to consider a stand-alone Chinese allocation that encompasses both onshore and offshore Chinese securities as part of a long-term strategy to capture higher returns than those available in developed markets.

Implications for Equity Investors

From an equity perspective, MSCI is proposing to add a higher proportion of China A-shares (traded onshore in China) to its broadly followed MSCI Emerging Market and China indices. A hypothetical full China A-share inclusion would take the proposed May 2020 total China weight (A-shares plus H-shares) from 32.16% to 40.3% of the EM index (see Figure 2). It would also increase China's weight in the MSCI All Country World Index from 3% to 5%.

Figure 2
Full Inclusion of China A-Shares Would Greatly Increase the Total China Weight of the MSCI EM Index
 Pro-forma weight of China in the MSCI EM Index by 2020



Source: MSCI, SSGA, 2018.

Such index changes plus the advent of the Stock Connect program (that links onshore and offshore markets) should render the distinction between the two types of shares (A and H) irrelevant. This would make it feasible for global investors to run a unified all-share China equity strategy. We think this is preferable to running a separate A-share only strategy as higher quality and investable Chinese companies tend to be listed offshore and the valuation differences between the two types of shares can be large.

Given the potential inefficiencies in this market, we would recommend investing in China with a skilled active manager who is able to capture the maximum alpha available. For a typical portfolio, we would recommend adding a dedicated China all-share equity strategy within an EM allocation, which would enable flexible and direct top-down control of the portfolio's overall China exposure, an increasingly important equity-allocation parameter.

Implications for Bond Investors

Bond Connect, the fixed income equivalent of Stock Connect, has made it easier to invest in onshore Chinese bonds. If China is added to all fixed income indices, including the Bloomberg Barclays Global Aggregate index, there is scope for about USD 420 billion² of inflows. However, it is worth considering that most of the bonds being added are not liquid, and a bulk of the flows would be used to buy Chinese government bonds (CGBs). Liquidity constraints will drive a larger share of foreign flows to the on-the-run (that is, those most recently issued) CGBs, which could trigger a rally in these bonds and a consequential repricing of other bonds as well.

With more offshore investors involved in the Chinese bond market, we are likely to see an improvement in the market's efficiency, which could further attract foreign interests and increase the global asset allocation to China. There is a structural demand for Chinese bonds purely from the weight of the yuan in the IMF's SDR.³ The yuan is the third-largest component of the SDR basket, with a weight of 10.9% as of August 2018; however, the yuan represents only 1.4% of the Composition of Official Foreign Exchange Reserve (COFER).⁴ If the gap between the two closes, this would likely generate structural demand for Chinese assets, which could be captured with a beta allocation to Chinese and EM local currency debt. Including China in major bond indexes should reduce overall exposure to developed countries' debt, which might put upward pressure on developed market yields.

2 State Street Global Advisors estimates using the Barclays Global Aggregate, JP Morgan GBI-EM and FTSE Russell World indices and based on the assumption that active managers will buy stocks in anticipation of index flows.

3 The IMF's Special Drawing Right (SDR) is an international reserve asset to supplement its member countries' official money reserves. It represents a basket of five currencies: the US dollar, the euro, the Chinese renminbi (or yuan), the Japanese yen and the British pound. The renminbi was added most recently in 2016.

4 The IMF's COFER database tracks end-of-period quarterly data on the currency composition of official exchange reserves.

Glossary

MSCI China Index

Captures large and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 461 constituents, the index covers about 85% of this China equity universe. Currently, the index also includes Large Cap A shares represented at 5% of their free float adjusted market capitalization.

MSCI China A Share

Captures large and mid-cap Chinese stocks listed on the Shanghai and Shenzhen exchanges.

MSCI Emerging Markets

Captures large and mid-cap representation across 24 Emerging Markets (EM) countries. With 1,151 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI World ex USA

Captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries—excluding the United States. With 1,015 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

Bloomberg Barclays Global Aggregate Index

Is a flagship measure of global investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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