STATE STREET GLOBAL ADVISORS

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.

Laura Ostrander
Emerging Markets Macro Strategist

George Bicher
Asset Class CIO and Portfolio Manager

Andrew Xiao, PhD, CFA
Senior Portfolio Manager, China Equity

Abhishek Kumar, CFA
Head of Emerging Market Debt

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.

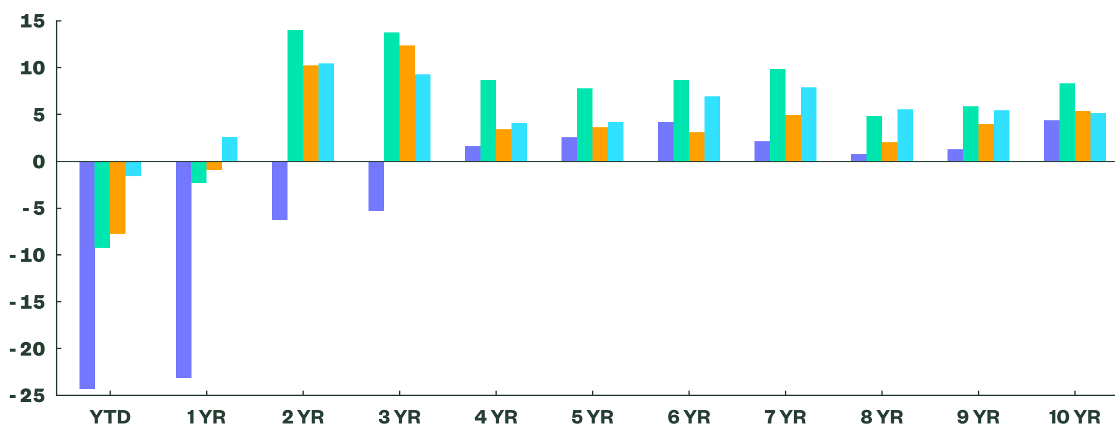
Despite expectations that growth will slow, in our base-case scenario China is expected to grow 6.5% in 2018 and around 6% in 2019. This compares favorably with an average of 2.4% for advanced economies in 2018 and 2.2% in 2019. Meanwhile, the economy continues to rebalance toward domestic consumption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



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

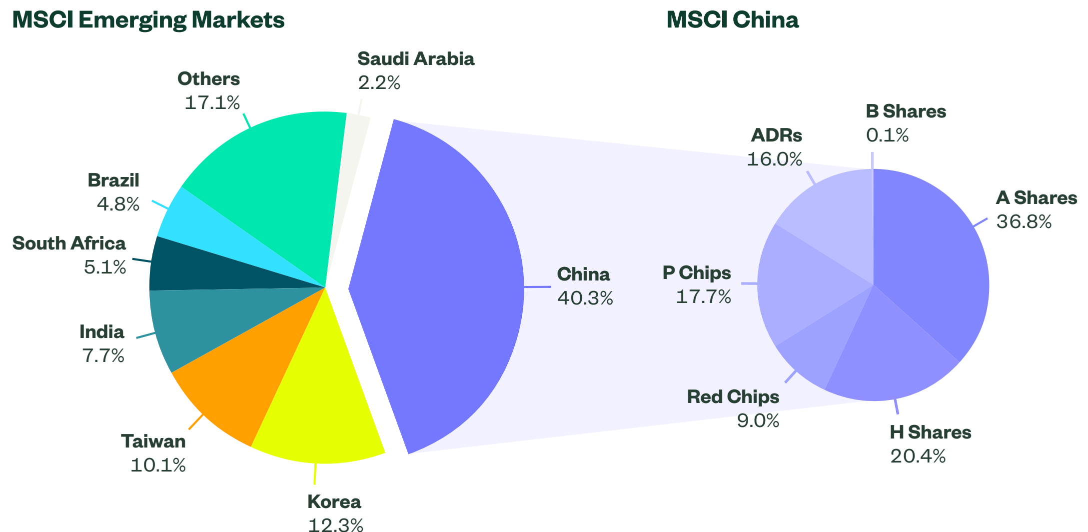
China remains one of the biggest underweights among EM investors, but has been swift to respond to the requirements of major emerging market equity and debt indices that wish to include, or that are considering including, onshore Chinese securities in a phased approach from 2019.

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 billion[2] 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.

MCSCI 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.

State Street Global Advisors Worldwide Entities

Abu Dhabi
State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Mayah Island, Abu Dhabi, United Arab Emirates.
T: +971 2 245 9000

Australia
State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia.
T: +612 9240-7600

Belgium
State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036, SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

Canada
State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900

Dubai
State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15 -38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA).
T: +971 (0)4-4372800

France
State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00

Germany
State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381.
T: +49 (0)89-55878-400

Hong Kong
State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong.
T: +852 2103-0288

Japan
State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan,
T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.

Ireland
State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221.
T: +353 (0)1 776 3000

Italy
State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), with a capital of GBP 62,350,000, and whose registered office is at 20 Churchill Place, London E14 5HJ. State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 06353340968 - R.E.A. 1887090 and VAT number 06353340968 and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy
T: 39 02 32066 100

Netherlands
State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands.
T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom.

Singapore
State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore)
T: +65 6826-7555

Switzerland
State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00

United Kingdom
State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ.
T: 020 3395 6000

United States
State Street Global Advisors, 1 Iron Street, Boston, MA 02210
T: +617 786 3000

Disclosure

Important Information:

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without State Street Global Advisors' express written consent.

This document may contain certain statements deemed to be forward-looking statements. Please note that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.

Generally, among asset classes, stocks are more volatile than bonds or short-term instruments. Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. U.S. Treasury Bills maintain a stable value if held to maturity, but returns are generally only slightly above the inflation rate.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Investing involves risk including the risk of loss of principal.

© 2018 State Street Corporation. All Rights Reserved.
ID14933-2293658.1.1.GBL.RTL 1118 Exp. Date: 11/30/2019