

China awakens

Weekly Digest

4 June 2018

– *Jeromine Bertrand, CFA*

If you checked the MSCI Emerging Market Index last Friday, you would have noticed the inclusion of 226 new A-Shares of Chinese companies into the benchmark. This is the first step of a very gradual introduction which will continue in September and A-shares only represent 0.4% of the index at present. While it might seem insignificant, it has triggered a wave of forced buying by passive strategies and could ultimately have a large impact on the composition of the index and investors' investment universe. In fact, if all those stocks were fully included along with additional mid cap names over time, China could come to represent 50% of the Emerging Markets of which 28% from A-Shares!

Historically, A-Shares, which are mostly listed on Shanghai and Shenzhen stock exchanges, were solely available to mainland citizens while foreign investors could only access Chinese equities via the offshore market -companies incorporated in Hong Kong ("H-Shares"), or ADRs listed in foreign markets. The Chinese government has gradually opened its onshore market with the creation of two "Stock Connect" facilities with Hong Kong and an increase in daily quotas. While managers were initially hesitant about the lack of direct ownership rights and limits on funds' repatriation, many have grown more comfortable and are now actively investing.

Why is it an important development? China's equity market has a total market cap of \$12trn making it the second biggest in the world but, despite being bigger than the Euro Area, the World Index and Emerging Market Index only include the offshore market at a respective weight of 5% and 30%. While the H-Shares market represents about 700 companies and \$2.8trn market cap, the Shanghai and Shenzhen markets are much deeper with more than 3500 stocks and \$8.5trn market cap! The A-Shares market is

arguably more attractive than the offshore one because it is more balanced and diversified across sectors and more representative of the domestic economy. The recent inclusion opens a bigger and different investment universe for investors and is a very important step towards a greater opening of the Chinese onshore equity market.

Today foreign investors' allocation to A-Shares is relatively small but it will change as the market becomes more institutionally-friendly. While the market has done very well in 2017 and is no longer cheap, valuations are still reasonable on a forward P/E basis given high growth expectations for the large caps vs their historical average. Valuations are however a lot higher at the smaller end. Investing in A-Shares isn't without risk but the market suffers from misconceptions as high volatility, poor ESG standards, trading suspension and corporate scandals grab the headlines. However, we believe this is a favourable environment for active managers which should be able to take advantage of mispricing and avoid the riskier companies.

Portfolio managers favour managers with a broader investment universe to build the China exposure because they are able to pick the best investment opportunities regardless of their listing and can invest in any stock with significant exposure to China. Where suitable, they think our portfolios already have an appropriate exposure to the Chinese domestic economy and are well positioned to take advantage of its expected growth without having a dedicated allocation to Chinese equities. However, portfolio managers will continue to review dedicated managers in the A-Shares markets that can complement existing allocations as more funds become available.

The Marketplace

- Gold fell 0.6% an ounce to 1,295
- Global trade tensions rumble on
- Brent Crude oil rose 0.8% to \$76.7 a barrel
- US treasury yield breaches 3.1%

Market Focus

US

- U.S. is set to impose tariffs on steel from EU, Canada and Mexico. At the G7 this week retaliatory measures are expected to be announced unless the escalation is wound down
- Non-farm payrolls for May beat expectations at 223k versus 190k expected
- The Dow Jones fell 0.7% to 24,635
- The Nasdaq rose 1.9% to 7083.9.

UK

- EU indicates it is preparing for the UK to crash out with no deal unless the UK lays out its position in more detail next month
- The FTSE 100 fell 0.2% to 7701.

Europe

- Italian bonds plunged as the country began to prepare for a potential new election.
- Eurozone headline CPI for May was 1.9% yoy (versus and expected 1.6%) and core CPI rebounded to 1.1% versus 10% expected
- The Eurostoxx 600 saw its biggest decline since March and ended the week down 1% at 386.9
- Spain's Prime minister Rajoy suffered a vote of no-confidence in the Spanish parliament with the socialist leader Sanchez his replacement
- Two of Europe's biggest banks, France's Societe Generale and Italy's Unicredit are considering a merger.

Asia

- The Hang Seng index fell 0.3% to 30,049.9
- China is planning to open up its markets to the EU at a summit this July. Areas of opportunity include finance and clean energy markets. This is seen as a response to the US's America First policy
- The Nikkei 225 index fell 1.2% to 22,171.

Asset Class/Region	Currency	Currency returns			
		Week ending 1 June 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-0.6%	0.0%	1.8%	12.9%
United Kingdom	GBP	-0.6%	0.0%	1.6%	5.3%
Continental Europe	EUR	-2.3%	0.0%	-0.8%	-0.9%
Japan	JPY	-1.4%	0.0%	-2.9%	12.5%
Asia Pacific (ex Japan)	USD	-0.8%	0.0%	-0.4%	15.7%
Australia	AUD	-0.3%	0.0%	1.0%	9.4%
Global	USD	-0.8%	0.0%	0.5%	10.9%
Emerging markets equities					
Emerging Europe	USD	-0.5%	0.0%	-7.8%	7.1%
Emerging Asia	USD	-0.9%	0.0%	-0.4%	17.1%
Emerging Latin America	USD	-3.6%	0.0%	-8.3%	3.2%
BRICs	USD	-0.6%	0.0%	-0.1%	21.6%
MENA countries	USD	0.8%	0.0%	8.2%	10.7%
South Africa	USD	-3.8%	0.0%	-11.7%	6.3%
India	USD	2.2%	0.3%	-2.6%	8.5%
Global emerging markets	USD	-1.4%	0.0%	-2.6%	13.7%
Bonds					
US Treasuries	USD	0.7%	0.0%	-1.2%	-0.7%
US Treasuries (inflation protected)	USD	0.8%	0.0%	-0.5%	0.9%
US Corporate (investment grade)	USD	0.7%	0.0%	-2.7%	0.1%
US High Yield	USD	-0.1%	0.0%	-0.2%	2.2%
UK Gilts	GBP	1.1%	0.0%	1.0%	0.9%
UK Corporate (investment grade)	GBP	0.4%	0.0%	-1.4%	-0.1%
Euro Government Bonds	EUR	-0.4%	0.0%	-0.2%	0.5%
Euro Corporate (investment grade)	EUR	0.0%	0.0%	-0.6%	0.7%
Euro High Yield	EUR	-0.4%	0.0%	-1.3%	1.5%
Japanese Government	JPY	0.1%	0.0%	0.6%	1.0%
Australian Government	AUD	0.7%	0.0%	1.3%	1.4%
Global Government Bonds	USD	0.5%	0.0%	-0.6%	2.1%
Global Bonds	USD	0.4%	0.0%	-1.3%	1.9%
Global Convertible Bonds	USD	-0.1%	0.0%	0.6%	2.4%
Emerging Market Bonds	USD	-0.8%	0.0%	-5.1%	-3.8%

Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	1.6%	0.0%	-3.5%	-0.5%
Australian Property Securities	AUD	0.2%	0.0%	-0.1%	-0.7%
Asia Property Securities	USD	-0.8%	0.0%	0.8%	9.7%
Global Property Securities	USD	0.4%	0.0%	-1.2%	6.8%
Currencies					
Euro	USD	0.1%	0.0%	-2.9%	4.1%
UK Pound Sterling	USD	-0.2%	0.0%	-1.7%	3.2%
Japanese Yen	USD	0.6%	0.0%	3.5%	2.4%
Australian Dollar	USD	0.1%	0.0%	-3.1%	2.5%
South African Rand	USD	-1.7%	0.0%	-2.3%	2.2%
Swiss Franc	USD	0.7%	0.0%	-1.1%	-1.3%
Chinese Yuan	USD	-0.4%	0.0%	1.6%	6.2%
Commodities & Alternatives					
Commodities	USD	-0.2%	0.0%	7.3%	19.4%
Agricultural Commodities	USD	-0.7%	0.0%	6.6%	4.3%
Oil	USD	1.5%	0.0%	16.0%	53.2%
Gold	USD	-0.1%	0.0%	-0.3%	3.0%
Hedge funds	USD	-0.2%	0.0%	-0.7%	2.6%

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