Five reasons to consider China as a standalone asset allocation

These include: size, diversity, and China's unique macro, risk and development factors

Aidan Yao,
Senior Economist (China)
Macro Research – Core Investments

Shirley Shen,
Economist (Emerging Asia)
Macro Research – Core Investments

Key points

- The accelerating integration of China into the world's financial market will have a profound impact on how global investors allocate capital. While most agree that China is too big to ignore, there is no consensus yet among global investors on how to manage the China exposure in their existing portfolio.
- This note outlines five reasons to consider China as a standalone allocation given its economic size, financial market diversity, unique risk characteristics, differences to other emerging markets and the anticipated impacts of its ongoing financial liberalization.
- These arguments, in our view, make a strong case for China to sit alongside the US and Europe as a large and distinct investment asset class, where dedicated resources are devoted to managing the unique risks associated with the world's second largest market.

China is too big to ignore

China's meteoric rise since the late 1970s has been touted as one of the most striking developments in the world over the past half century. However, most of this rise has been associated with China's economic achievements, while developments in its capital markets have generated less attention. This is despite the equally impressive growth in China's equity and bond markets which has made them the world's second largest today. However, because most of these markets were, until recently, closed to foreign investments, **China was an "economic opportunity" difficult to convert to "capital-market gains".**

That situation has started to change in recent years. Not only have domestic reforms – such as interest rate and Initial Public Offering (IPO) liberalization – picked up apace, Beijing has also expedited the opening-up of its capital market via channels like the Stock and Bond Connects. Together with the inclusion of RMB assets into global indices, China has become a choice destination for global capital in the past few years.

So, with the world's second largest market increasingly open for business, **the question facing most investors is not whether they should invest in China, but how they should do it.**

For the few early-movers – those who entered China via QFII and RQFII schemes[1] – RMB assets are generally managed as part of an emerging market (EM) portfolio. Such a treatment makes sense to the extent that China, despite its aggregate size, is still an EM economy based on per-capita income, its capital market is as volatile as other EMs, and its policy and regulatory environment is still underdeveloped.

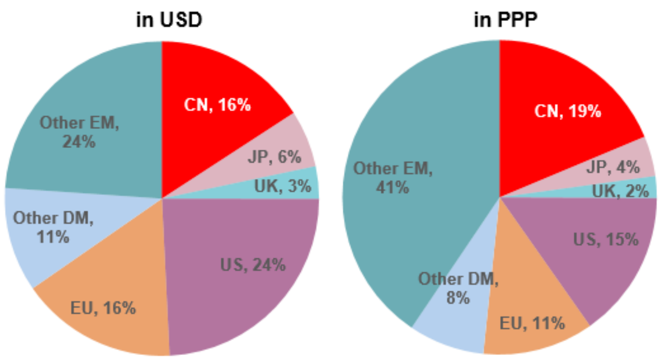
While many of these arguments are still valid today, **we see an increasingly compelling case to look at China as a standalone asset class.** In the remainder of this note, we explain five reasons why global investors should devote dedicated resources to manage their China exposure.

#1: China has vast scale

For those who follow China closely, the size factor is obvious. China is the world's second largest economy, accounting for 16% of global GDP in USD terms. However, on a purchasing price parity (PPP) basis, China was already the world's largest economy since 2014 and made up almost one-fifth of global GDP last year (Exhibit 1). While China's economic growth has slowed over the past decade, the incremental output added by its 6.6% growth last year was still larger than the full economic size of Australia.

Exhibit 1: China has become an economic juggernaut

GDP share of world in USD and PPP terms, 2018

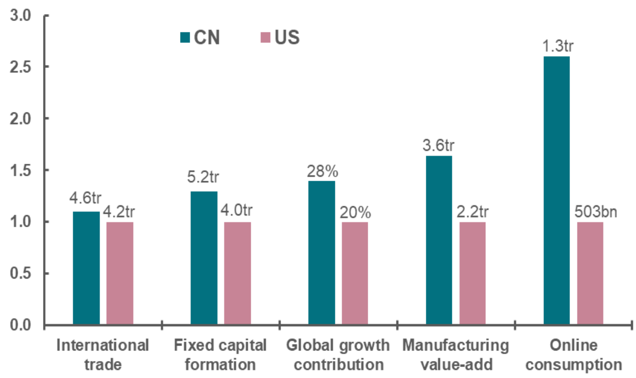


Source: International Monetary Fund (IMF) and AXA IM Research – As of 29/08/19

While China is still behind the US in GDP size (in USD terms), **it has surpassed the latter on a number of partial measures**, including international trade, fixed asset investment, contribution to global growth, manufacturing value-added and total online consumption (Exhibit 2). To the extent that economic size matters for how global investors allocate capital, **these measures suggest China is large enough to be considered as a standalone investment.**

Exhibit 2 China surpasses the US in some areas

Comparison between China and US (y-axis: US=1, bar labels = actual size)

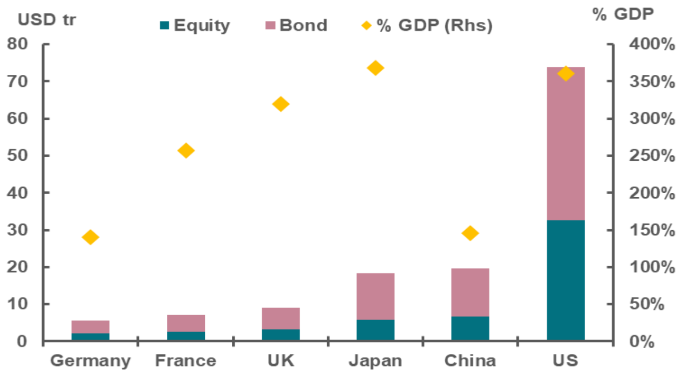


Source: IMF, US Census, CEIC and AXA IM Macro Research – As of 29/08/19

Besides the economic scale, China has grown its financial-market clout too. It was not so long ago that China was an under-capitalised economy before its equity and bond markets came to existence. **Today, China is the world's second largest market, with combined equity and bond market caps larger than those of the UK, France and Germany put together**. Notably, China has achieved this with a still-low level of market-cap-to-GDP ratio (Exhibit 3). **Should the latter continue its convergence to DM levels, ongoing financial deepening would fuel further growth in China's capital markets.**

Exhibit 3: China is the world's second largest market

Equity and Bond market capitalization by major countries



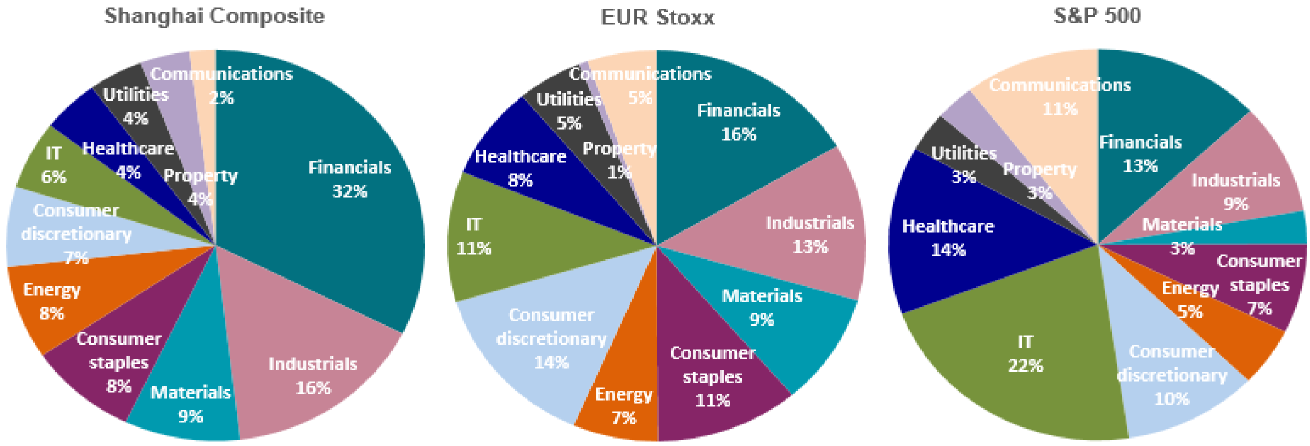
Source: Bloomberg, Bank of International Settlements (BIS), CEIC, and AXA IM Macro Research – As of 29/08/19

#2: Chinese market is deep and diverse

Beneath the aggregate size, what investors also care about is the market depth and diversity. To be worthy of a standalone asset class, a market has to be well diversified to allow investors to spread risks and deep enough to enable an easy deployment of large capital. Exhibit 4 compares the industry composition of the Shanghai Composite with those of the S&P 500 and Eurostoxx 50. The A-share index has the full 11

[1] Qualified Foreign Institutional Investor scheme and RMB Qualified Foreign Institutional Investor scheme

Exhibit 4: A-shares are as diverse as major DMs

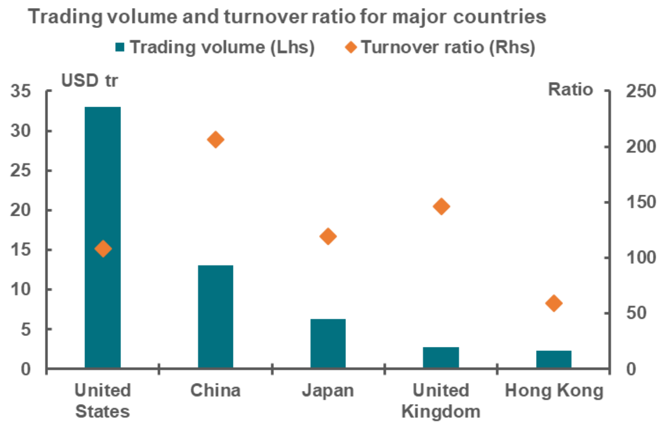


Source: Bloomberg and AXA IM Macro Research – As of 29/08/19

major sectors categorised by GICS[2], with a total of 1,519 listed companies. While financials and industrials make up a large portion of the market, their weights have declined over time as the economy rebalanced[3].

Liquidity conditions of the markets are also comparable to major developed markets (DMs). Exhibit 5 presents the trading volumes of the world's five largest equity markets. While the absolute dollar transaction of China is lower than the US due to its smaller market size, China stands out with the highest turnover ratio thanks to the frequent trading of its retail investors[4].

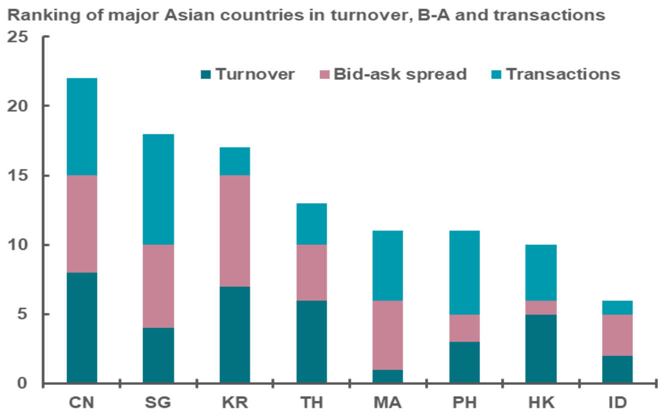
Exhibit 5: A-shares are deep and liquid



Source: World Bank and AXA IM Macro Research – As of 29/08/19

Comparable information on the fixed income side is difficult to find globally, hence our analysis focuses narrowly on Asia. Exhibit 6 shows the ranking scores of bond market liquidity based on the turnover ratio, bid-ask spread and average transaction size. China ranks favourably in all three measures and is rated the overall most liquid market in the region. **Overall, the analysis above suggests that China has comparable technical features to the world's most liquid and diverse markets.**

Exhibit 6: China bonds are the most liquid in Asia



Source: Asian Development Bank (ADB) and AXA IM Macro Research – As of 29/08/19

#3: China is fundamentally different to other EMs

The perceptions around what binds EM countries are, in our opinion, increasingly questionable. EMs are clearly not a homogeneous set of markets, whether focusing on demographics, current account positions, debt levels or sensitivity to commodity prices. In aggregate, the group is less developed and has lower levels of income per-capita, so in this respect China shares common ground with others. However, we believe that China is increasingly standing out from the crowd in some important respects. These include:

– **A different monetary policy cycle:** EMs, as an asset class, are known for their sensitivity to the Fed's policy (and hence movements of US interest rates and dollar). China, on the other hand, has a monetary policy more anchored

---

[2] Global Industry Classification Standard

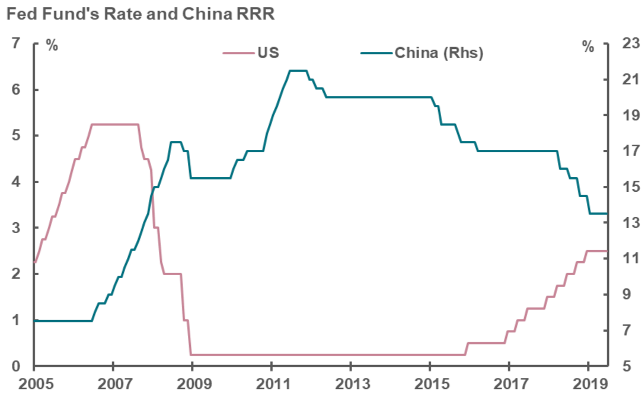
[3] Once combined with the Shenzhen Composite – the other major bourse in China – the sector weights of A-shares are more balanced.

[4] Liquidity underpinned by retail flows may not be considered as reliable as institutional liquidity for some investors.

around its domestic economy. In fact, China's monetary policy cycle – proxied by the RRR movements – has been negatively correlated with that of the US over the past 15 years (Exhibit 7).

– **Net commodity importer rather than exporter:** Many EMs exhibit common business cycles in part because they are net commodity exporters. Resource-rich countries in Latin America, Middle-East and parts of Asia (e.g. Indonesia) fall into this category. China, on the other hand, is a net importer of commodities, meaning that the rise and fall of global commodity prices will have an opposite impact on it compared to others.

Exhibit 7: China has independent monetary policy



Source: Bloomberg and AXA IM Macro Research – As of 29/08/19

Low correlation of asset prices: Chinese asset markets are less correlated historically with peers thanks to the insulation provided by its closed capital account. Exhibit 8 shows that adding Chinese equity and credit to global portfolios can lower total volatility and, in most cases, boost expected returns. Our portfolio simulation shows a consistent increase in the Sharpe Ratio upon a 10% allocation to RMB assets (Exhibit 8, right hand side chart). To the extent that part of this risk diversification is achieved by China's controlled capital account, future liberalisation would likely erode this benefit. However, we expect this process to proceed slowly and be managed carefully by the Chinese authorities.

The above macro differences between China and other EMs need to be assessed by global investors when they try to design the best strategy to investing in China.

#4: China's unique risks require tailored solutions

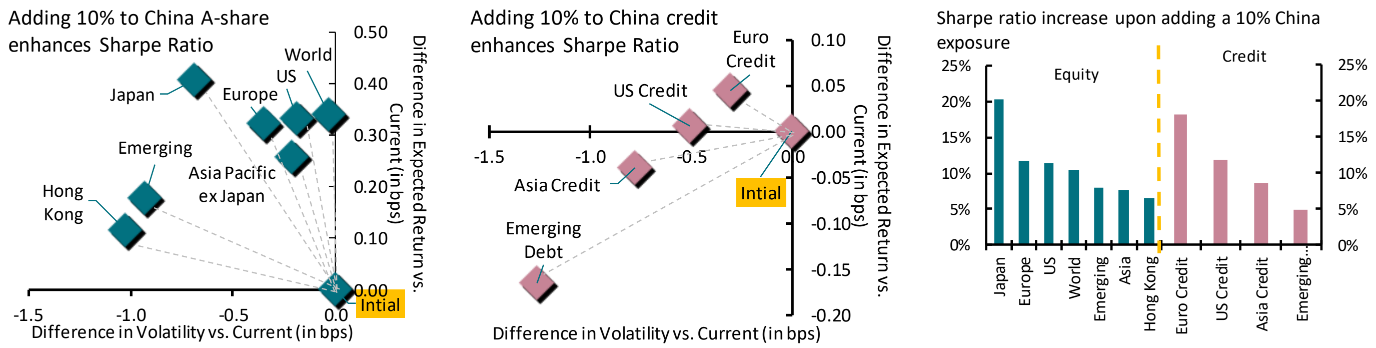
Apart from the unique macro factors, **investing in China can also expose global investors to policy and regulatory risks that are not commonly found elsewhere**. Here are a few examples:

– **Market regulations –** particularly those concerning foreign investors' access to the onshore markets. While these regulations have been relaxed considerably, the level of openness of the Chinese markets is still below those of major EMs. Future changes of Beijing's liberalisation policies will likely continue to drive the scope of foreign investors' activities in these markets.

– **Macro policies** which can influence the economy and markets, like they do elsewhere. However, China's policy making is not only opaque, but different in many ways. For example, China's monetary policy has multiple objectives – some of which, such as maintaining exchange rate stability and orderly balance of payments – are not common among other central banks and are what gives the People's Bank of China (PBoC) a wider reach. To fulfil these goals, the central bank manages a large number of tools, ranging from interest rates and RRR to short-term liquidity facilities, all of which can significantly influence capital markets. Finally, the decision-making process is not transparent, with no pre-set announcement dates for monetary and fiscal policies. Understanding these idiosyncratic factors can be important for ensuring investment success in China.

– **FX regime** of the RMB, which is half-way between fixed and floating. While the PBoC has officially exited regular FX intervention, it still carries the discretion to step in if needed. This means that the FX market can switch across regimes – from those of market forces setting the price of RMB to those of market panics where the PBoC has to intervene to provide stability. While most EM authorities

Exhibit 8: Lower correlation between China and global assets can add value



Source: Bloomberg, CEIC and AXA IM Research – As of 29/08/19 also manage FX to various degrees, the level and frequency of intervention have been higher in China and could remain so depending on the authorities' commitment and delivery of future reforms.

– **Market structure,** which can determine the characteristics of China's investment landscape. Like a typical EM, China's equity market is dominated by retail investors, who tend to behave speculatively and prefer to invest in small-cap growth stocks[5]. Both equities and bonds have onshore and offshore market splits, where prices of nearly-identical assets can vary significantly[6]. Finally, international credit ratings are not yet available in the onshore bond market, whereas local ratings often lack credibility. Until the standards converge, foreign investors will have to rely on their own credit assessment.

The above discussion presents a mere subset of the unique policy and regulatory risks existed in China. **These risks, in our view, are best managed by people with deep experience and knowledge of norms in China.**

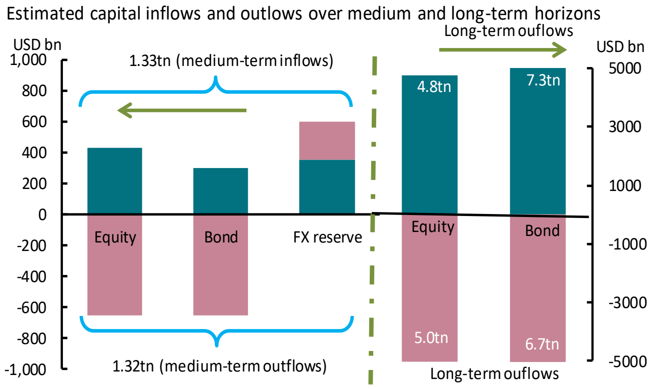
#5: China's financial open-up offers opportunities

Our previous report[7] on China's balance-of-payment transformation foreshadows a shift in the global financial system caused by the liberalization of the world's second largest capital market. **This process is intricately connected to how global investors view China as an investable market.** Here is why:

First, China's closed capital account has severely limited its integration in the global financial system over the past decades. **But that situation is changing by the gradual relaxation of capital controls that will make China an ever-larger share of the global asset market.** The MSCI, for example, predicts that Chinese equities will make up almost half of its EM index once the full allocation is given to A-shares.

Second, **the growth and liberalisation of the Chinese markets should create significant "active" opportunities for global investors.** The internal rebalancing of the Chinese financial system should accompany a shift in household asset allocation, from properties to equities and bonds. Externally, continuation of China's capital account liberalisation could trigger tens of trillions of in/out capital flows over time (Exhibit 9). These flows would change China's financial landscape and create exciting opportunities for active investments.

Exhibit 9: Financial liberalisation causes gigantic flows



Source: Various sources and AXA IM Macro Research – As of 29/08/19

Finally, **a successful rise of the RMB as an international reserve currency could change the global monetary system.** A shift – from a singular regime centred on the USD to a multi-polar system underpinned by the USD, EUR and RMB – would take time and require China to deliver further and substantial reforms.[8] But the process has already started, kicked off by global reserve managers allocating to RMB assets after the yuan was included in the IMF's SDR basket. A continuation of this trend could strengthen China's position in global markets and propel the yuan's status as an international reserve currency.

[5] In China, retail flows account for almost 90% of daily trading volumes of A-shares, higher than most EMs.

[6] The latter can offer arbitrage opportunities as the market barriers are gradually removed.

[7] Yao, A. and Shen, S., (2019) "China: source of tectonic shifts in global finance" AXA IM Research & Strategy Insights, 10 September 2019

[8] For sure, such a process could only be achieved over the very long term and would require China to continue to carry out critical reforms.

Our Research is available on line: http://www.axa-im.com/en/insights

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826