Chinese equities

2018 growth may moderate, but reforms and innovation bode well for the longer term

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Key takeaways

- For 2018, we are expecting a moderation of growth.
- That said, there are several encouraging signs that may support better quality growth in the longer term.
- Going into 2018, we maintain our optimism for Chinese equities.

Chinese equities caught investors by surprise in 2017 with a strong rally. Contrary to the pessimism over the past few years, investors have turned upbeat toward China, and for good reason: Economic data in general exceeded expectations, and we have seen broad-based earnings growth.

For 2018, we are expecting a moderation of growth. That said, there are several encouraging signs that are worth monitoring. In our view, these will be supportive for a transition to better quality growth.

- Progress in deleveraging
- Supply-side and state-owned enterprise (SOE) reforms
- Industrial innovation
- Structural southbound liquidity
- MSCI A-share inclusion

Growth expected to moderate in 2018

We are of the view that gross domestic product (GDP) growth will gradually moderate in 2018 from 2017 levels, but should be on track to deliver the government's target of around 6.5% growth.[1] We believe consumption and services are the structural drivers for China's GDP growth going forward. Income growth continues to be strong in the high single digits. We believe consumption and services will continue to drive the economy in 2018, as underpinned by urbanization and rising income trends.

Investments and exports are expected to soften going into 2018. However these are less of a concern in our view. Exports, for instance, are unlikely to become a key growth contributor, given that China's export share to G3 economies has largely stagnated since the start of this decade. We expect the Fixed Asset Investments (FAI) in real estate to slow, as that is in line with the overall policy to prevent a property bubble. We believe the government's shift toward a Private-Public-Partnership (PPP) model, with the aim to attract private sectors to co-invest, is a very encouraging sign.

Progress in deleveraging

We have seen positive progress with China reining in overall debt in 2017, and we believe deleveraging will remain a high-priority agenda item for the government in 2018. So far, we have seen ongoing policy tightening in the financial industry in an effort to temper irrational credit growth. Results have been encouraging. Wealth management products, one of the proxies for shadow banking, have shown contraction in recent periods. We believe progress in deleveraging will continue in 2018, although in the short term, we may see pressure in terms of funding for smaller enterprises in China, which could weigh on short-term growth in 2018. However, over the longer term, a reduction of overall financial risk should lead to stability and better quality growth going forward.

Supply-side and SOE reforms

Supply-side reforms have seen remarkable progress over the past two years, with the coal and steel industries achieving their capacity curb targets faster than expected. We expect more disciplined supply-side controls to continue into 2018, leading to a more favorable supply-demand balance in industries with excess capacity.

We believe one of the key solutions to the problem of outstanding debt is to fix SOEs' lack of competitiveness. Early 2017 saw some positive momentum, and we expect this to continue. We have started to see SOEs increasing their dividend payouts and introducing mixed ownership in their structure. Both of these steps are evidence of the change in mindset to make companies more profitable and market-driven.

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Industrial innovation

We are already seeing industrial innovation happening. Research and development (R&D) spending in China has increased fivefold since 2005, growing at 18% per year, and with the second-highest R&D investment globally.[2] With government policy support, we expect China to further move up the value chain. Becoming one of the top-ranked innovative nations by 2035 is a key government priority, and we can see that it is moving in the right direction.[3] The government is committed to fostering innovation-driven growth. With rising labor costs, we expect increasing automation to enhance productivity and efficiency gains in 2018.

Structural southbound liquidity
We are seeing strong flows from mainland Chinese investors into a broad group of Hong Kong-listed Chinese equity stocks. Currently, the MSCI China Index consists entirely of Hong Kong-listed Chinese equities (i.e., H-shares+)[4] and offshore American Depositary Receipts (ADRs), despite the MSCI A-share inclusion scheduled to happen in 2018. Year-to-date, US$28 billion has flowed into the Hong Kong stock market via the southbound link of the Stock Connect program.[5]

Our view is that the southbound flows signify a structural, long-term allocation to Hong Kong stocks by mainland Chinese investors. We believe these flows are here to stay because more mainland Chinese insurance and institutional investors are coming to the H-shares+ space in search of unique investment opportunities that are not offered elsewhere. Looking into 2018, we believe robust southbound flows will provide supportive liquidity to Hong Kong-listed Chinese equities.

> In our view, the positive developments of southbound liquidity and MSCI inclusion only mark the beginning of a rising asset class.

MSCI A-share inclusion
The "yes" decision in 2017 to include China A-shares in the MSCI Emerging Markets (EM) and China indexes is a milestone development. 2018 will see the first step of inclusion, with MSCI adding 231 A-share stocks to its EM and China indexes. The initial inclusion weight in 2018 is not meaningful, estimated to represent 2.6% of the MSCI China Index and 0.8% of the MSCI Emerging Markets Index. Our view is that A-share inclusion will provide a more complete investment universe for global investors and will better reflect the entire Chinese economy. Looking ahead, we should see increasing allocation to Chinese equities as an asset class, and this should be worth the attention of investors.

Conclusion
We have seen positive earnings upgrades in 2017, and we believe Chinese companies remain on track to deliver 2017 earnings growth of 17.9%, compared to -9.4% in 2016.[6] We do not see the earnings trend reversing in the medium term, although the rate of growth in 2018 may not be as strong as in 2017. The expected earnings growth for 2018 is 15.8%.[6] Despite the strong rally in 2017, China is still trading at reasonable valuations. The MSCI China Index is trading at a 15.8x price-to-earnings ratio, which is largely at the historical mean, and at a 14% discount to developed markets.[6]

While China's topline growth is expected to moderate, there is encouraging progress on the deleveraging and reform fronts that can help China achieve a balanced growth economy. Going into 2018, we maintain our optimism for Chinese equities. In our view, the positive developments of southbound liquidity and MSCI inclusion only mark the beginning of a rising asset class.

1 Source: Xinhuanet. The Chinese government set the 2017 growth target of around 6.5% during the annual National People's Congress (NPC) held on March 5, 2017.
2 Source: UBS research, estimates as of Sept. 28, 2017. It is estimated that China could exceed the US spend by 2018 in purchasing power parity (PPP) terms if the current growth rate continues.
3 Source: Credit Suisse research, quoting President Xi Jinping's speech at the Party Congress held in October 2017.
4 "H-shares" are defined by the Hong Kong Stock Exchange as companies that are incorporated in mainland China and whose listings in Hong Kong are approved by the China Securities Regulatory Commission (CSRC). This group of companies forms an integral part of the offshore Chinese equities listed in Hong Kong. In this outlook, "H-shares+" refers to a broader definition that includes H-shares, red chips and other Hong Kong-listed Chinese companies.
5 Source: Goldman Sachs, year-to-date data as of Sept. 27, 2017. Launched in November 2014, the Shanghai-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shanghai and Hong Kong stock markets. Launched in December 2016, the Shenzhen-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shenzhen and Hong Kong stock markets.
6 Sources: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, Invesco, as of Oct. 20, 2017

Important information

All data as of October 31, 2017 unless stated otherwise.

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