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China: Investment Opportunities & Outlook for 2022 and Beyond

The Chinese equity markets performed especially well in 2020, but the actions of the government and regulators have conspired to turn sentiment negative in 2021, and prices have come tumbling down. Is the concept of 'common prosperity' therefore perhaps a game-changer to the negative for investors in China's equity and debt markets, especially as it comes along as a huge surprise and so close to the reining in of China's big techs and the growing anxieties over excessive debt throughout the economy, as evidenced by the problems at Evergrande Holdings? Or are these simply puffs of smoke masking the incredible opportunity that China still represents for investors of all types and for many years ahead, with investors needing to recalibrate, re-analyse the government priorities, and invest with the behemoth state's tailing winds at their backs? And what does all this mean for China's vast onshore fixed income market, which has gradually been opening up to foreign participation? Or for the offshore debt market? In short, where are the right opportunities to find return and value, what should investors avoid, and how, if at all, should they approach accessing those vast Chinese investment markets? The Hubbis Digital Dialogue of November 25 saw a panel of experts from the asset management and wealth management communities offering their perspective on the value that China still represents, on the right approaches for Asia's private clients, and what to watch out for in the future as warning signals that the economy, the markets or geopolitics might be going off track.

SPEAKERS

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JIAN SHI CORTESI
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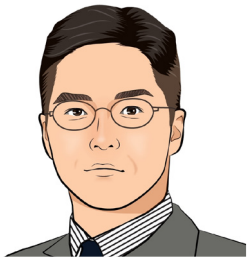

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THESE WERE SOME OF THE QUESTIONS THE PANEL ADDRESSED :

- As projections for economic growth have been trimmed in recent months after the power cuts and a series of other negative news, should investors be concerned, or is growth still so robust compared with the global norms that they should remain positive and well invested?
- Are the Chinese government's actions during 2021 aimed at taking more state control of the economy, or at ensuring that risks are better managed and some of the excesses scaled back for more stable growth in the future?
- Are China's equity markets over-valued, fully valued or undervalued and why?
- What sort of exposures should Asia's HNW and UHNW private clients have to China as a percentage of the APAC portfolios and their overall global portfolios, and why?
- Where are the best opportunities in China's equity markets, i.e., which sectors and which types of companies should investors focus on?
- How should investors access China's equity markets, 'A' shares, 'H' shares, via stocks listed in the US, or in Europe? What are the advantages and disadvantages of each approach?
- Should investors be buying active funds managed by the China watchers and experts? Or plain vanilla ETFs? Smart beta and thematic ETFs? Or all of the above?
- Broadly, how should investors be positioning themselves for the next 2-5 years or even beyond?
- Should private clients in Asia be looking also at China's vast fixed income markets, especially after the concerns over debts in the property sector?
- If they are interested in taking some exposure, what would be a sensible approach and how should they consider accessing this market? Onshore debt? Offshore debt? Via active funds? Via passive funds? And why?
- Are foreign credit rating agencies making headway in the onshore market both from a regulatory and also a credibility point of view?
- What are the political, economic or financial dangers ahead and what should investors watch out for?
- Is there any genuine risk of political, financial or currency instability ahead?

A great performer in 2020, but regulatory tightening and emerging government policies have burst the balloon in 2021. But many argue value is emerging again...

An expert opening proceedings by highlighting how in 2020 China was one of the best performing markets in the world, and this year, one of the worst performing, as investors blinked in face of the regulatory tightening and other somewhat concerning government actions. But he said most of the negative, or worrying news has been priced into the stock prices, with some of the large caps down 50% from the peak, some midcaps down 60% to 70% from their peaks.

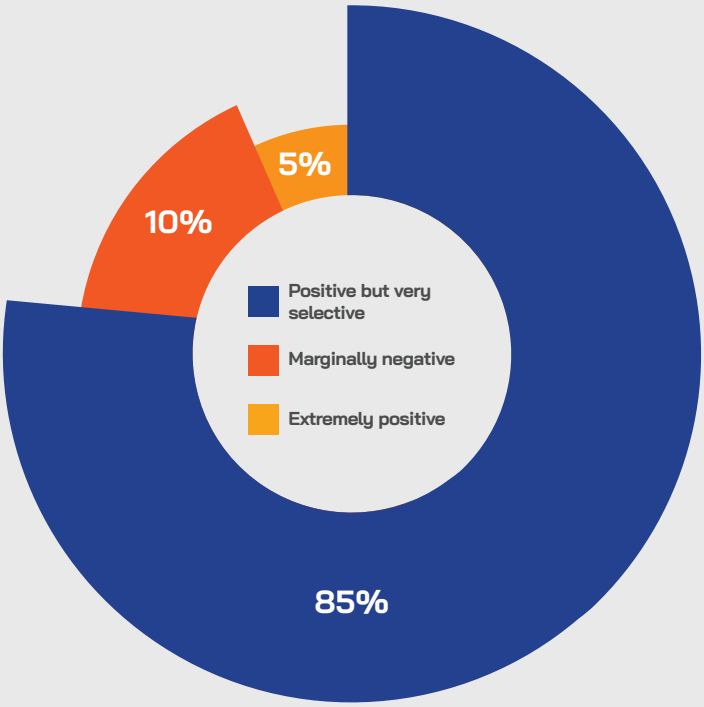
"We scaled back exposures in Q1 when we saw valuations so stretched," he reported, "we moved much more defensive, and now that the market has corrected and many single stocks have corrected quite dramatically, we are again finding opportunities, as we see some interesting stocks trading close to historical low valuations. Accordingly, recently, we have started to increase exposure. In the year ahead we don't need good news from the policy side, we just need to have little or no news and that will already be enough for the market to go up. All in all, we look forward the next two to three years to see strong performance coming out of China."

Changing government policies and regulations might be a short-term negative, but there is a bigger picture evolving

A guest said some of the policy and regulatory tightening is related

The Hubbis Post-Event Survey

WHAT IS YOUR OUTLOOK FOR CHINESE EQUITY INVESTMENTS FOR THE YEAR AHEAD?



Expert Opinion

JIAN SHI CORTESI, Investment Director, GAM Investments

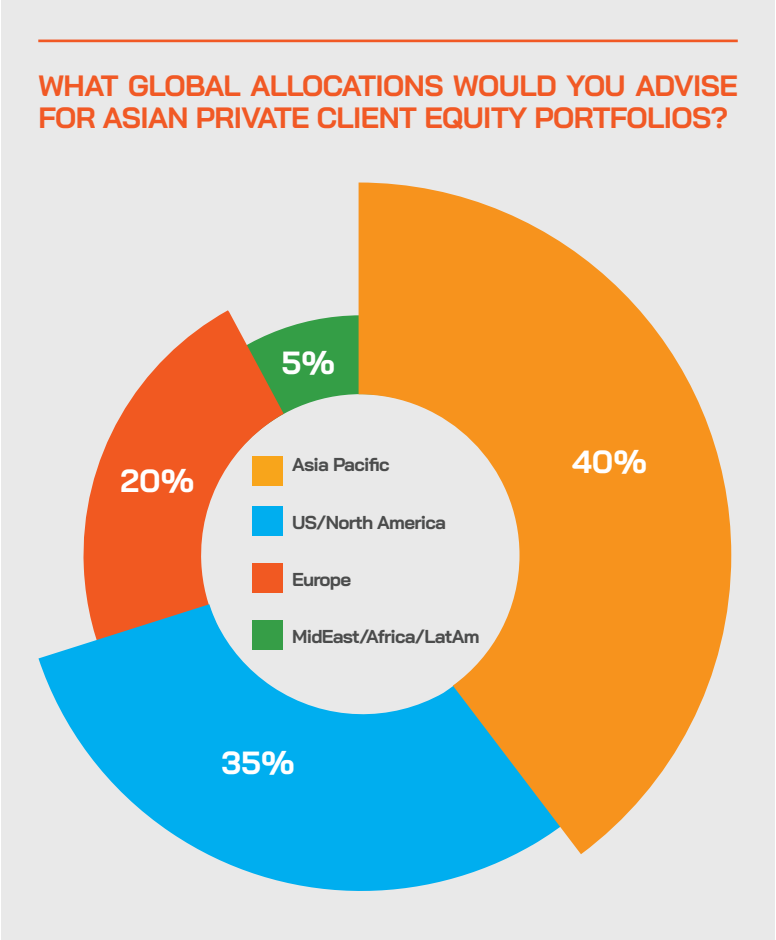
"Regulatory changes in China in 2021 have been decried by some investors. We believe, however, that many are positive for the long-term health of the domestic economy. The most exciting opportunities, in our view, can be found among 'rising star' companies that should be poised to benefit from anti-monopoly regulations. We believe companies at the forefront of this clean energy revolution are the ones to watch, as China aims to achieve carbon neutrality by 2060. This means clean energy is set to shift from being a peripheral source of energy in China to the predominant source over the coming decades. In general, our view is that investors should not write China off. We believe that understanding the shifting dynamics and being nimble enough to respond to them through a style-agnostic approach is key for investors to realise the many opportunities that exist in Chinese markets."

to scaling back the excesses to avoid risks in the future, such as in the property market. "But overall, many of the policies and the grand scheme of things in our view, are designed to ensure the long term rise to achieve China's long-term goals," he said. "Remember that China was the leading civilisation until the 1800s, then declined from a global perspective, and only in the last 30 years is rising again. I think the goal of China, or maybe the Chinese government, is to have the revitalisation of the Chinese civilisation, eventually making China one of the very richest and most powerful countries. And some of the recent measures also aim to reduce the social frustration as a result of the widening wealth gap. And this is positive for the long-term sustainability of the continuous productivity increase in China."

Looking ahead, the pieces of the puzzle might fall into place, and investors should look for the STAR performers

Another panellist said we must look ahead, for example to the second year of the 14th five-year plan. "Usually, after the first year of planning, or budget approving, the second year will see the execution of various projects beginning, so investors should be really focused on what will be or which kind of company or sector will benefit from this," he advised. "Big Data, Cloud Computing, AI, blockchain, semiconductors, all this will be the core technology that Chinese government would be really eager to develop."

He said watch out for the STAR market which in 2020 he thinks will be eye-catching. The STAR market launched around two years ago in Shanghai as a new board, and now boasts approaching 350 listings, which he said include future emerging leaders in technology.



Chinese equity discounts have deepened, market could perform robustly but perhaps not actually outperform vs global stocks

An expert reported that it is unlikely that there will be sufficient macro easing to lead to outperformance in China relative to global equities. He said stocks are valued at around a 30% discount relative to global indices, compared with roughly a 17% discount historically. "But we're not looking for significant policy stimulus coming through from the Chinese authorities, so although Chinese equities still might do relatively well, we're not sure they will actually outperform within a global equity context."

Bonds still represent an opportunity, despite the Evergrande debacle

The same guest said there has been obvious weakness in the bond market, challenges in the property sector, and the selloff in the high yield Dollar credit space. "But our view is that there is actually a very significant opportunity for investors," he stated. "One of our key calls is that Asia high yield, actually Asian credit generally will do well and outperform within a global context. You've got yields that are over 7% in this space, and on a diversified basis. And in today's

environment, when yields are still pretty low, obviously, higher than they were a year ago, but still very low globally. We think that's going to be very attractive given the Chinese authorities will not want this to spread and become self-sustaining or lead to feedback loops on the economy more broadly. We think there's still scope for investors in Asia to allocate more to China equity and debt."

But policy revamps and surprises deter plenty of investors

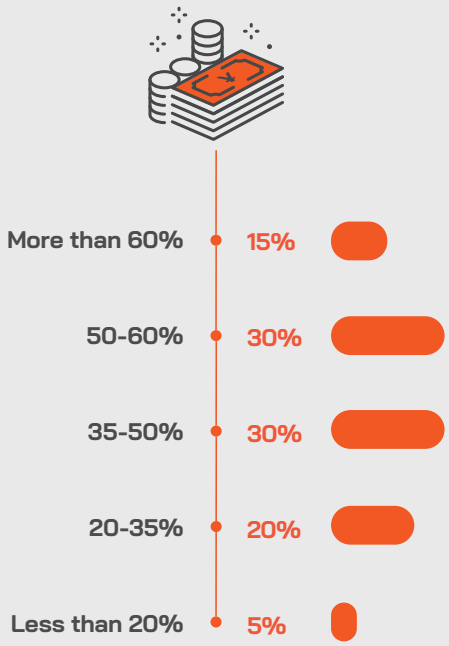
However, another guest said he felt it is not a good time to invest when policies are evolving rapidly, and change is afoot. "We're in very much policy territory, and quite frankly, we don't really know whether it's a good time to invest in the market," he commented. "It is very difficult to work out valuations. Yes, prices have fallen and what goes down must come up, but right now it is really difficult to form strong fundamental views about a market where policy can change overnight, even if you see some of the potential changes in the tea leaves as a fellow guest mentioned."

But he said China represents great potential ahead. Investors need to focus on why they want to be in China and what they want to hold. "Don't hold China for China, hold the special stocks and sectors, go with what China is really good at."

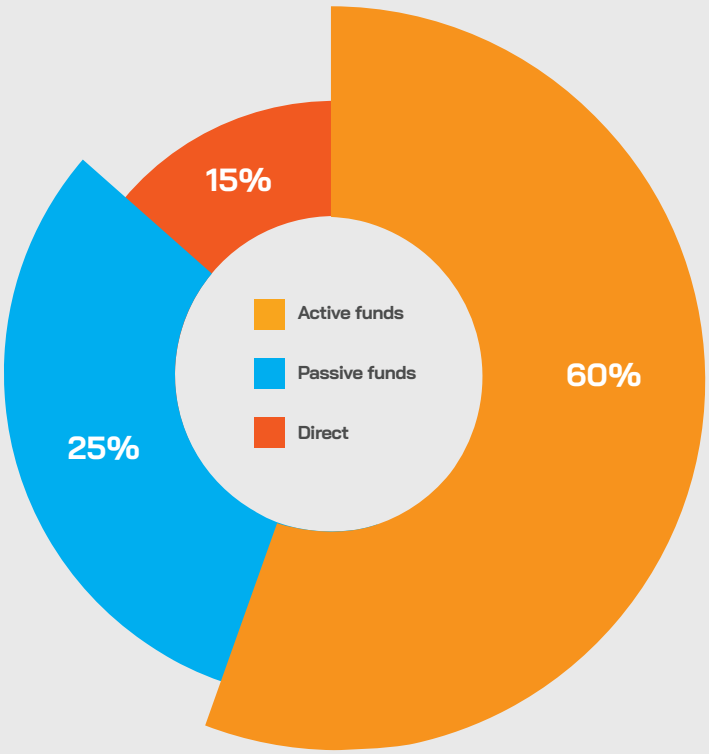
When the wind is strong enough, even pigs can fly, so get the wind at your backs...

"There is a Chinese saying that when the wind is strong enough, even pigs can fly," an export quipped. "Do we want to buy China as a whole, or invest where

WHAT PERCENTAGE EXPOSURE SHOULD ASIA'S PRIVATE CLIENTS HAVE IN THE CHINESE EQUITY MARKETS AS A % OF THEIR APAC EQUITY HOLDINGS?



WHAT IS THE BEST APPROACH TO CHINESE EQUITY MARKET INVESTMENTS FOR ASIA'S PRIVATE CLIENTS?



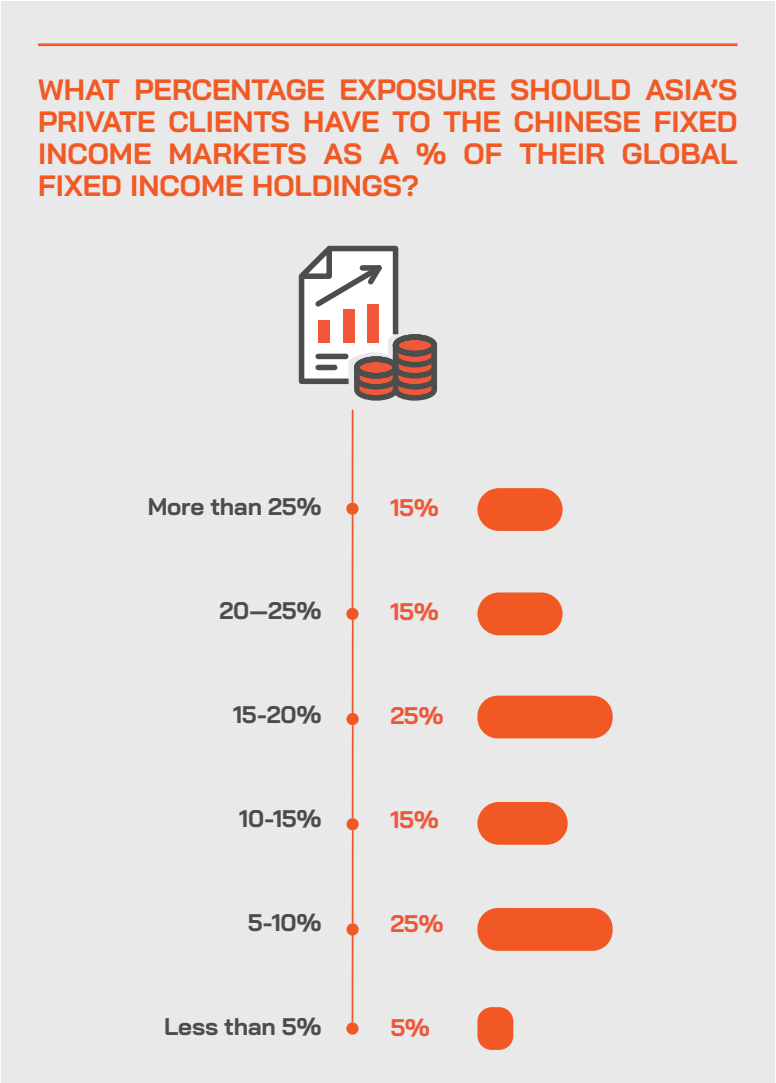
the wind is at my back? We can see from government policy what sectors they support for the future, so for example semiconductors and technology components. And China has a huge ambition in clean energy, already accounting for 70% of the global solar module production, about half of the wind turbine production and already accounted 40% of electric vehicle sales. be a lot of opportunities in clean energy. And then there is digital and innovation, AI and other key areas. These areas are where we focus for our stock picking."

He added that China's geopolitical angle and the self-sufficiency angle are very closely intertwined. Semiconductor self-sufficiency is vital, he indicated, as the country needs to make sure it is producing what it needs for its own future, such as the critical components, and does not need to rely on what it appears to deem unreliable Western partners. "And that means bringing a lot more onshore, and making sure that you generate that productive growth," he said. "Common prosperity doesn't mean redistribution from one part of the pie to another part of the pie solely. It's also making sure that the pie continues to grow at a reasonable pace."

Choose your exposures wisely, but make sure you are in China for the longer term

Another guest concurred, with this view. "I think as an international investor, if you want to invest in China, you have to really think about whether you want a highly beta exposure, like tracking the benchmark CSI 300 or the Mega Cap A50, but that may not be the way that how China will grow in near term. You actually want to be in China, the second largest economy, with a rising position in the benchmarks, but the real question is which particular exposures do you want." And he agreed that following sectors of the economy that the government clearly backs is vital.

This same expert pointed to a flagship 3173 New Economy ETF that has been enjoying the phenomenal growth in the past few years. "It has continued to outperform the benchmarks," he reported, "and we think next year, the overall New Economy themes will resume growth, because the overall appetite will improve."



He added that some of the very large institutions had been loading up exposure to China government bonds, as yields of 3.5% at 10 years and beyond are very appealing, alongside the A1 rating and momentum or at least stability of the Renminbi.

Agility and flexibility are vital for the right investment approach

An expert advised investors to be agile. "For example, last year in November, when China announced the Carbon Neutrality Goal for 2060, we started adding wind and solar names into our portfolio, and they

soon performed really well, some stocks have already doubled or tripled," he reported. "The ability to adapt portfolios rapidly and follow the signals is vital."

Balanced perspectives on 2022, with the experts erring on the side of optimism, but only just

An expert reported that his firm was neutral on 2022 because the fundamentals are so opaque in China at the moment. "Policy can be granted and taken away," he observed. "Some companies benefit more than others, sometimes at the expense of others. And we've all been hurt in the past by backing the wrong horse there." Nevertheless, he feels there are opportunities, certain key sectors China is clearly good at or improving at significantly, such as electric vehicles, AI, high-end manufacturing and others. "Those are what international investors are looking for," he said. And he added the currency had been strengthening recently, and policy would suggest a strong to stronger Renminbi.

The property sector needed reining in to attain affordability and help the government's drive towards common prosperity

A guest remarked that property in China had risen some 10% in 2020 and 7% this year, but amidst many complaints about affordability. The government has therefore tightened purchases, resulting in weakened cashflows for the developers, at the same time as asking the banks to reduce lending to highly leveraged property companies, such as Evergrande.

Expert Opinion

DAVID LAI, Partner & Co-Chief Investment Officer, Premia Partners

"In 2022, investors should start looking at STAR market, which is the platform launched two years ago to home-groom domestic leaders in hardcore technologies such as semiconductor and EV supply chain. At Premia, we do provide a cost-efficient HK-listed ETF tracking the top 50 STAR stocks (3151)."

"My best case is that I think we will see default in some companies, even though maybe on paper not default, in other words they will have to go through restructurings. On the other hand, we're actually seeing the higher quality real estate property stocks outperforming in China, and not just outperforming the property sector, actually, outperforming the overall market because some of these companies may be taking over some unfinished projects from the troubled developers and they're most likely taking over these projects at attractive terms. And the government will probably also lean more towards the stronger developers in terms of land sales. In short, all of this is possibly positive for these high quality developers, so we, for example, have one such stock in the portfolio that had been punished together with the other property names. The market will be

more differentiated between the weak and the strong from now on."

Another guest agreed, adding that they had been seeing inflows to their China US Dollar Property Bond Fund, with some bargain hunting taking place amongst family offices or small institutions.

Approaching the technology sector requires selectivity that was not needed so mush before

News of an app update for Tencent being banned had provided more reasons for uncertainty around technology stocks, and an expert said he felt that much tighter scrutiny will continue, especially as in the US and Europe there have been greater concerns and more actions over some of the Big Techs, including actions over anti-trust/monopoly. The problem has been more the suddenness and the pace of the tightening in China this year. "The issues centre on the power these companies have and their diversification into new business areas due to their power, and the government wants more competition," he observed. "The government wants to look at what is best for the nation, so one can see this as directing a better allocation of resources to areas the government wants to encourage, such as automation, industry 4.0, robotics, semiconductors, EVs, AI and so forth."

Hong Kong's role as the investment entrepot to China? The signs remain generally positive

An expert rounded of the discussion by observing that Hong Kong remains relatively open in terms of information flows and deep in terms of the capital markets expertise, "Hong Kong might feel slightly less appealing than before, when things were really very good, but Hong Kong still has a number of advantages that China doesn't have, for example information flows, expertise, background, diversity of services and history, and so forth." He added that Hong Kong has remarkably limited land, so he does not expect a major spill-over from the Mainland in terms of the real estate sector. "In all, I think Hong Kong will remain the key gateway to China, and Chinese investors will remain positive too."

Expert Opinion

STEVE BRICE, Chief Investment Officer, Standard Chartered Private Bank

"We look at China through 3 lenses: domestic macro policy, domestic micro policy and finally geopolitical considerations. From a macro policy perspective, China appears more willing and able to take short term pain to achieve a more sustainable longer-term path. Therefore, we doubt we will see a sizeable macro stimulus in the coming 12 months as the authorities do not want to be caught in a debt trap that much of the developed world finds itself in.

Through a micro lens, it is clear that the authorities want more inclusive growth, such that the gap between the haves and have-nots narrows, or at least we see a greater focus on equality of opportunity. This means some sectors/companies will remain under significant scrutiny and will need to take actions to show their inclusive intent or feel the wrath of increased regulation, aka reduced profitability. As far as geopolitics is concerned, China is clearly targeting greater self-sufficiency, given its increasingly turbulent relationship with the West.

What this means for investors is it is going to be harder to make the call as to whether China equities will outperform or underperform global equities. Therefore, the focus needs to shift to which sectors or industries are likely to thrive in this environment. For us, three potential areas to focus on are hard manufacturing, semiconductors and renewable energy.

In bonds, it is easier to make a case for Chinese USD-denominated bonds to outperform their US or European counterparts at least over the next 6-12 months, given attractive valuations after this year's property sector-driven sell-off. The bonds are pricing in significantly higher corporate default rates compared to history, which we do not think the authorities will allow."

The final word – valuations are relatively cheap and taking a longer-term view should pay off

The final word went to an expert who observed that in terms of valuation, things are quite cheap on a historical basis, with the CSI300 PE around 14.9 times. "People focus

too much perhaps on the short-term challenges that China is facing, but actually quite a lot of good news is being brushed aside, for example China is explicitly supporting many key sectors for the future, the US-China relationship is improved, many regulations have already been rolled out. If investors take a longer-term view and are well diversified, I think they're likely going to do well. And it doesn't take a lot of positive news to lift the Chinese capital markets. So, that is what we have been saying to our clients." ■

Expert Opinion

DAVID LAI, Partner & Co-Chief Investment Officer, Premia Partners

"On the fixed income side, we have observed there are increasing interests from wealth platforms in our China USD property bond ETF (3001) despite the rising credit default risks. Premia China Treasury and policy bank bond long duration ETF (2817) also sees decent inflows on its relatively high yield and solid sovereign rating."

The Hubbis Post-Event Survey

WHAT DOES THE EVERGRANDE CRISIS MEAN FOR FOREIGN INVESTMENT IN CHINA'S VAST FIXED INCOME MARKETS?

- They will switch from fixed income to equity.
- Shift further to equities.
- Valuations in China's fixed income markets may become more attractive.
- More detailed risk management has to be conducted.
- Evergrande is an enormous company embedded across China's financial system and economy, hence the fixed income markets will suffer broadly.
- Investors have to analyse the debt and management of issuers more thoroughly, and less driven by name recognition, and they should now be more cautious about the potential shifts in Chinese government policies and regulation.
- Due diligence not good enough in China.
- Clearly, confidence has been hit hard.
- Investing in fixed income in China not only needs market and industry analysis, we also need to understand the government's strategic positioning.
- Outflows driven by concerns and uncertainty over the lack of transparency.
- It will test the debt restructuring procedures, and there might be some positives from this, but on the short to medium term it is negative.
- Very simple – steer clear of highly leveraged sectors or companies.

- This crisis will surely have some shorter-term repercussions but the market should absorb and adjust to the higher risks over time, while costs should rise for the issuers if normal market trends are followed.
- For foreign investors, we think they are little protected, as they are viewed as institutional investors who should understand the default risks and therefore, they may have to look at some types of amend and extend, i.e., they may have to take a haircut on their principal, or see their coupon being paid at a much later date. This is mainly due to the Chinese government's goal of maintaining social stability which is to address the needs of home buyers first, and part of the new commitment to 'common prosperity'.
- The Evergrande crisis is a critical alarm to foreign investment in Chinese vast fixed income markets, and foreign investors should be more cautious of the Chinese regulatory changes, potential policy changes, and should also be alerted to reassess conglomerates firms' credit management control systems in order not to fall into those risky asset classes and sectors.
- It is better to invest China fixed income markets via well-diversified funds.
- The valuation methodologies used in the past 10 year have serious flaws - there are significant default risks in these fixed income markets that really have not been priced in.
- Over leveraged real estate developers were flagged some time ago. Those that carried on investing and borrowing heavily have been hammered. Those willing to change their stripes (not so much leverage, having enough float to ensure the company can remain operations in times of stress, not hanging citizens out to dry when troubles start) will survive and thrive. In fact, picking up parts of Evergrande at discounts could be very attractive for other developers. For the bond market in general, it is probably best to sit back for a while. This also applies to Asia too since China weightings in an Asian index are now quite high.

IS CHINA'S GOVERNMENT BACKTRACKING ON LIBERALISATION, OR AIMING TO ENSURE THAT RISKS ARE BETTER MANAGED?

- We see this as managing risks, things are actually improving.
- Aimed to ensure the well-being of the society as a whole.
- They are aiming to ensure risks are managed, but the heightening risks of more regulatory crackdowns will continue to haunt the market.
- I think China government is backtracking on liberalisation.
- Sensible intentions, for the long-term structural social stability and balanced economic growth.
- Both slowing liberalisation and also to ensure risks are better managed.
- Back tracking on liberalisation for the moment, or perhaps more on pause.
- They want risks to be better shared and ensure a more harmonious economy and social stability.
- We believe there is no backtracking on liberalisation and the approach is to make reforms and ongoing liberalisation to bring broader economic prosperity.

- The Chinese government is smart in managing their country. I think the recent regulatory crackdown is aiming to ensure that risks are better managed for their long-term goals.
- It will help them get control of crises such as Evergrande and reduce the likelihood of future excesses.
- The government does not appear to be backtracking, but instead making a clear swing in direction for the country to move in the next level of industrialisation, including in sustainability, especially first cleaner energy, all of which will help lift the GDP per capita from the income trap and improve lives.
- I don't see the government backtracking. They have changed direction, but I don't see these things as backtracking. They have quite often used 'sandpits' as means for an industry to grow and mature. But they have always held that regulation will come. I think the education clampdown in quite smart and the US would be in a better position if it were to do the same. People associate liberalisation with US - the US is hardly an ideal role model in terms of corporate governance. They have allowed, and always will, all sorts of irrational excesses, but many blind eyes are turned in exchange for political patronage in the US.