CHINA'S INVESTMENT MARKETS:

IS THE GLASS HALF FULL OR HALF EMPTY FOR PRIVATE INVESTORS?

SUMMARY

Hubbis hosted a very timely Digital Dialogue discussion amongst China experts on September 14 to drill down into the opportunities on offer and the challenges ahead in China's investment markets. The reality is that the jury is still out as to whether China's short-term problems and longer-term structural issues are as bad as some paint them to be, and, if they are, whether they can be overcome in a timeframe to make it worthwhile for investors to buy back in. The China watchers at the discussion appeared largely to be of the view that negativity about China has been far overdone, especially in the Western media and markets, and that there are some major sectors of appeal for investors to participate in selectively and through the right products and strategies. The panel made a good case for seeing China as China and not conflating perspectives based on Western outlooks and attitudes. China's vast economy will keep growing, the government will keep directing policy, and China will continue to offer a market that includes a number of key sectors that are dominant global leaders. With valuations at historical lows and also relative to major markets, the advice, in short, appears that private investors should consider China selectively, focusing on world-leading products, innovation and excellence, government policy support and unsustainably low valuations.

SPEAKERS

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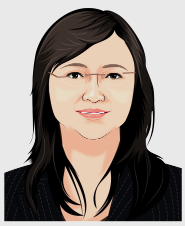

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Setting the Scene for the Discussion

As backdrop for the discussion, China's equity and capital markets entered 2023 in a more positive frame of mind, rising almost 20% through to late January from the recent lows of late October 2022. But the market then traded sideways until August, when sentiment towards China was hit hard as news emerged of serious debt troubles at Country Garden, China's hugely indebted and largest property developer. That news spooked investors, many of whom remember the Evergrande crisis of 2021, which was followed by a wave of defaults across the industry.

« Expert Opinion -Jasmine Duan, Senior Investment Strategist, RBC Wealth Management: "We are looking for structural and bottom-up opportunities in the short term. But it doesn't make sense to be more bearish at the current level. Investor sentiment is extremely pessimistic as investors are mixing up short-term cyclical problems with longer-term structural issues." »

The emerging crisis at the company seemed to be a catalyst for leading foreign investors offloading Chinese equities heavily since then, as they also focused more intently on a series of negative news, such as the vast economy looking set to miss its 2023 growth target of 5%, and crackdowns on tech giants such as Tencent and Alibaba, related apparently to national security concerns. Moreover, they focused more realistically on the further ramifications expected for them as international fund managers related to the US thrust to contain China's technological, memory chips and AI advances, amongst others.

The September 14 discussion brought delegates up to date on these big-picture developments, looking through the volatility and worries to the opportunities that China, the world's second-largest economy, still evidently clearly offers.

« Expert Opinion -Jasmine Duan, Senior Investment Strategist, RBC Wealth Management: "The recent breakthrough of the Chinese semiconductor industry would help to remove some concerns on technology restrictions, which could pave the way for market bottoming." »

Indeed, many leading global fund management names were, as recently as July, quite confident that China would be able to push through any crises of confidence, geopolitical worries and lower growth estimates, pointing to key sectors and individual stocks that they felt likely to outperform.

Moreover, valuations are compelling on a history and relative basis - the MSCI China Index has been trading only at around 10 times 2023 projections, while the S&P 500 Index has still been trading at more than twice that level.

Indeed, the glass-half-full story continues with views that the government has this year appeared, in general, to be clearer on its policies for the years ahead, making it far easier for investors to participate in state-preferred sectors, such as green energy, EVs, new age batteries, healthcare, and other key sectors that are core to China's future.

« Expert Opinion -Jasmine Duan, Senior Investment Strategist, RBC Wealth Management: "The recent series of policy announcements signifies that the government is cognizant of the economic challenges and is resolved to address them. Collectively, these stimulus measures could have a significant impact." »

Additionally, the country has appeared eager to further open up its capital markets. This is not surprising in the overall scheme of global capital markets - foreign investment as yet accounts for such a tiny proportion of China's equity markets, and prices are driven almost entirely by Mainland investors.

However, there are plenty of avenues for foreign investors to access China, such as through Hong Kong-listed H shares and also via other international markets. They can also buy into actively managed funds and ETFs that themselves buy into the domestic A shares. Or through Stock Connect or through the QFII and RQFII programmes, qualified foreign investors, including wealthy HNW and UHNW clients, can also buy in directly. And some of the wealth managers are offering structured products that mitigate downside risks while offering some degree of upside potential related to preferred sectors.

China is certainly facing some shorter-term and also longer-term structural issues, but some experts believe that these have been excessively amplified in the Western media and that, in reality, the outlook is far more encouraging

"Sentiment and news have been excessively pessimistic," an expert opined. "Investors are too often mixing up the shorter-term cyclical challenges with the longer-term structural issues. Remember also the pandemic hit China very hard, over some three years, and this is the first year of full reopening."

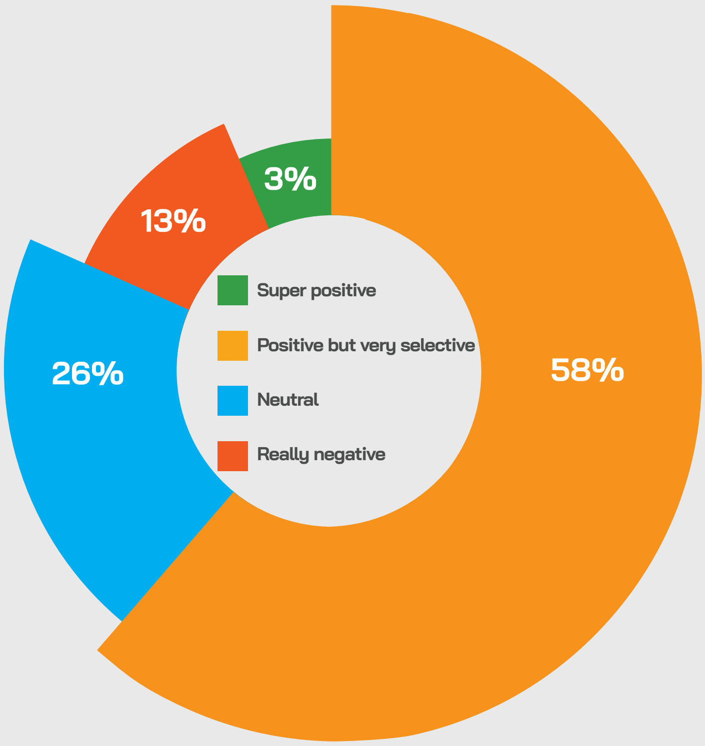
She said many are worried China is facing a period of deflation, but they ascribe that largely to the pandemic, as China is mostly self-sufficient in all key areas.

"China did not have much of a supply chain issue, and it did not send out helicopter money to the households," she remarked. "So, when the economy gradually comes out of the pandemic drag, and everything is back to normal, the effect can be deflationary. There are also plenty of inflationary indicators in the economy as well."

For example, she pointed to many of the consumer brands upgrading their products, going more premium, a typical Asian strategy. "If you go out to dine or for a massage in China, you will see prices are up, even though the CPI numbers do not really tell that story," she observed. "Why? Because one of the big components in the CPI basket is linked to property prices, dragging CPI down hard. We see China going through some short-term cyclical problems, and at the same time, there is a period of structural reform and structural upgrades. All this means that Chinese equities remain volatile."

The Hubbis Post-Event Survey

WHAT IS YOUR OUTLOOK FOR CHINESE EQUITY INVESTMENTS FOR THE NEXT 6-12 MONTHS?



But she pointed to the recent 'chips' breakthrough by Huawei as marking a major breakthrough for the Chinese technology sector, which will potentially lead to a tech stock recovery and also the overall Chinese market bottoming.

Amidst the barrage of negativity, valuations are very low on a historical and relative basis, and some would argue that multiples are far too low

Another guest opened her commentary by agreeing with a fellow panellist that China is indeed facing some cyclical challenges, but that these have been rather amplified in the Western media, producing more negative sentiment than is perhaps justified or fair.

"However, if you look at China's economy, there are some major drivers, perhaps most visibly in the technology space," she said. "And valuations are remarkably low, way cheaper than historical norms and compared to the US or other major markets and leading indices. This very evident relative undervaluation of Chinese equities points to a revaluation, but what we are now waiting for is the news to trigger that."

She explained that her firm's clients are still optimistic about some key sectors, such as big data, 5G and some areas of technology and innovation. She also pointed to a broad interest in healthcare amidst China's ageing demographics, noting that they had created tailor-made access to that sector in the form of a principal protected note.

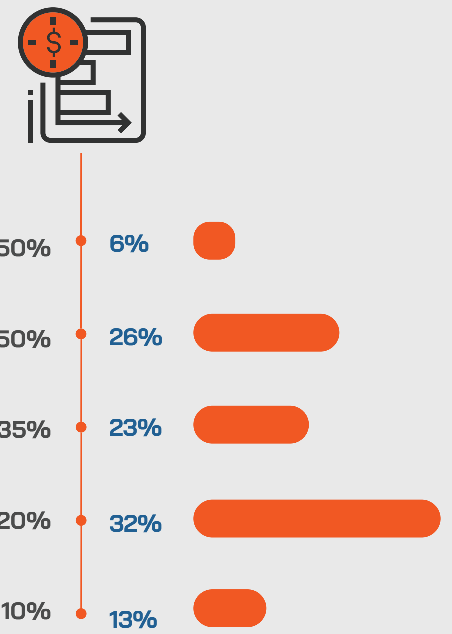
Protecting the downside, offering some upside

"Our clients tend to be on the conservative side; hence the principal protection structure and the upside is in the linkage to the key healthcare indices," she explained. She added that they had created another structured note that also aims to focus on those sectors in China that are likely to benefit from government policy tailwinds, especially the technology sector.

"China has been leading the world in some areas of advanced technology for some time," she reported, "whether it is 5G, renewable energy, EVs and batteries and so forth, and the government provides huge policy support for these types of preferred sector. We believe more investment opportunities around the areas may arise to attract fund flow from onshore investors and from overseas."

In light of the negativity on China generally, an expert reported that they are offering investors a risk-mitigated approach, through principal-protected structured products that downplay volatility and allow for upside participation. Sectors of focus would be food security, technology security, energy security, military security, and digital security, offering investors some interesting potential.

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



"Structurally, we're underweight China, and we prefer other parts in Asia, but tactically, we definitely see plays in China and have products to take advantage of those."

China is cheap and clearly has appeals, at least in part

Another China watcher turned his gaze onto the equity markets at large, noting that valuations are cheap by any measures, current and historical. And that led him to the ETF market, noting that there has been a significant shift in preferences from active to passive strategies for China.

"Originally, China was a full-on emerging market replete with many opportunities to produce alpha," he said. "That means funds would prefer active managers. But today, the mindset has changed – when we talk to institutional clients, their mindset seems to be more benchmark-focused, and therefore they increasingly like more passive strategies. That, in turn, means we see more institutions using ETFs as a tool to enter the China markets."

Sentiment was positive earlier in 2023, but has weakened through the year, and remains negative, especially since the property sector's major troubles reached the light of day

A panellist conceded that their firm's number one concern going into 2023 was indeed China's property market but that had only worsened, and today [mid-September], there was still no recovery in sight.

He also remarked that going into 2023, many people were anticipating the US recession – which has not materialised – and a China recovery, but that had also not come to fruition, or rather sentiment and news had worsened, especially since the extent of the property market stresses emerged.

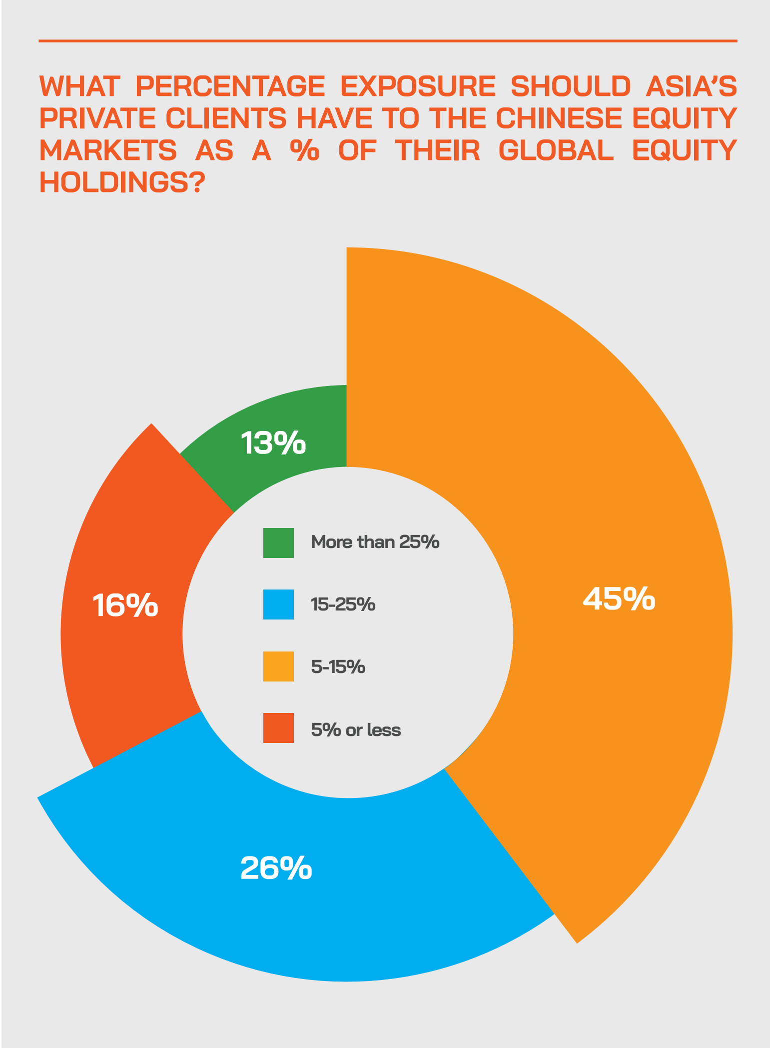
"The property sector's tentacles spread far and wide into a host of vital areas, including broader economic weakness, local government funding and also bank balance sheets.

"When the property train gets stuck, it means cash flows dry up in many areas, making for significant challenges in many areas," he explained. "Although there are improvements in spending on travel, restaurants, hotels and leisure activities, at the same time, the sheer scale of the property sector problems and their impact dwarf all that."

There is so much 'noise' for international private clients, even from Asia, that wariness dominates their perspectives about China

"Western investors feel a lot of geopolitical noise, and frankly, this is likely to continue for some time," another expert reported. "Hence the US, European investors, and even Middle East investors are shying away from China. In Southeast Asia, clients are wary, and only include China very selectively, for example, in regional bond portfolios. We have been seeing India, Japan, even Indonesia, getting a lot of the flows that would typically go to China at this stage."

He explained that they need to see Chinese money buying in heavily



again to their markets, moving money out of savings and money markets and into equities. "We need to see stronger and clearer government policy, and some real propelling of overall growth, not just turning the taps on in the property sector."

Another guest agreed with those comments but noted that mainland investors had been putting large sums of money into specific strategies and selected sectors in China through Hong Kong this year.

"In 2023 so far, we have seen big inflow into Hong Kong, driven by onshore China investors participating in our flagship ETFs, where we recorded record high inflows," he told delegates. "On the other hand, it is fair to say that foreign investors have been pulling out money from Asia and the Hong Kong market in general, with China's property market the latest number one concern, according to a survey conducted amongst US fund managers."

Distinguishing the positives from the apparent negatives

But a more positive case was put by another specialist. "We believe the market is overly discounting the negatives into the Chinese equities, just as happened last October [2022] after the politburo meeting," they reported. "As I said, people are too worried about longer-term structural issues from China, for example, the deflationary risk, the ageing demographics – comparing China to Japan several decades ago. But we try to explain our view that the impacts on the economy itself are not so serious."

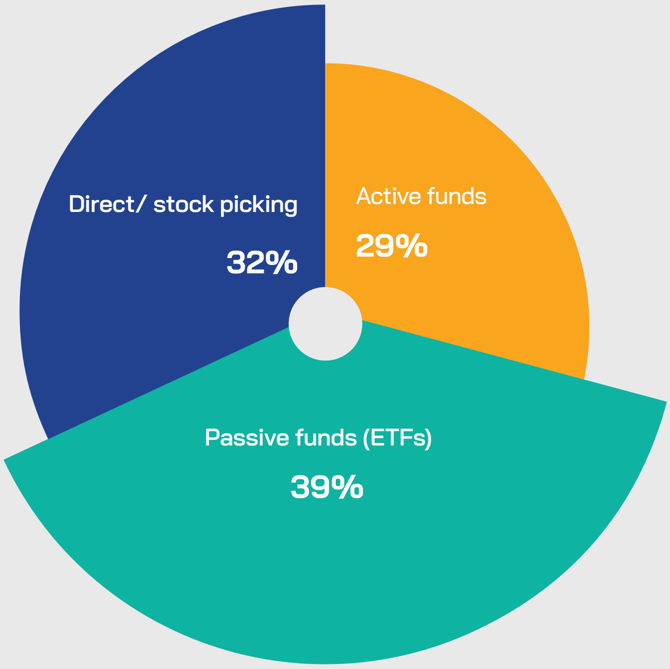
She explained that, for example, regarding a slowing and ageing population, that is more than offset by skills upgrading and productivity growth, whereas in Japan, productivity and GDP per capita are already very high. Korea's demographics have been slowing and ageing since the 1990s, but the impact has only been seen recently, several decades later, and anyway, Korea has been able to keep growing its GDP and GDP per capita, and there is plenty of room left to reach Japanese levels. "In short," she concluded, "there are plenty of reasons to be much more engaged in these areas."

Market watchers and investors call for the government to act more decisively

There is little doubt from the panel's comments that the scales appear somewhat tipped to the negative for China. However, a guest remarked that the government has realised that there is a significant problem, and they are doing something right now, albeit they are taking somewhat conservative steps. "Hopefully, they will be more proactive and emphatic, and also do a bit more on the fiscal policy side too."

He added that in light of weaker overseas demand – the central banks are trying to squeeze spending in the US and Europe – and that lack of overseas demand had meant that China remains somewhat stuck with apparent deflationary pressures.

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



"That is why we would like to see more aggressive policy support," he explained. "Although interest rates are much lower than in the West, they are still a burden for the credit market, so we think more can be done there. And we want to see more fiscal support, perhaps more infrastructure investment, new high-speed trains, and so forth. Nevertheless, we conceded that the problem there is there is rather an over-supply or too much capacity already, leaving less room for that type of stimulus."

He said that people will be watching carefully for signs of improvements, noting that any positive news on land and building sales will encourage a rebound in other sectors, including banks, insurers, building supplies, white and brown goods, furniture companies and logistics. "We see some intimations of that during recent weeks, but nothing that adds up to fundamental change so far," he commented.

China is China, and investors cannot assess it on the same basis as the US or other major economies and markets

A speaker opened his comments by remarking on how most people had been surprised by the performance of the major developed markets in 2023, given all the many Western financial and global geopolitical issues that remain largely unresolved.

"We are all still worried about inflation, about interest rates, and looking ahead, people are still absolutely in two minds, with one camp predicting a US recession and the other camp a soft landing," he observed. "Naturally, there are diametrically different approaches you would take to portfolio construction based on either of those outlooks. I think this is why we are seeing a lot of overreactions to news and often to single data points in the US. That is not a healthy situation."

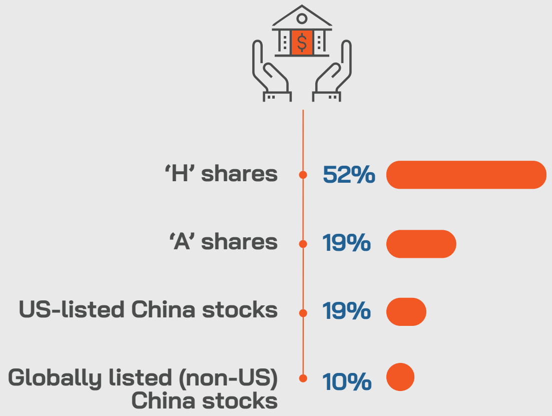
He observed that in the emerging markets, India has been a standout performer, while in China, the end of the pandemic restrictions had not yet translated to the widely anticipated growth boost.

Sentiment towards China has not yet rebounded

"That has all not played out as expected," he said, noting that official numbers from China are indicating that the country is currently unlikely to hit the 5% mark for GDP growth. Add to that the continued spats between China and some Asian countries, and particularly China and the United States, and he said it all means China has become rather difficult to navigate for investors.

He also commented that from the Western viewpoint, Asia might be considered rather homogenous, even today, but that is far from the case. "Many do not appreciate the cultural and other complexities and the geopolitical melting pot that is Asia in reality and find it incredibly difficult to look into China and understand what is going on there," he cautioned.

HOW SHOULD INVESTORS BEST ACCESS CHINA'S EQUITY MARKETS?



"They might, for example, wonder if the Chinese government might provide what we could call the "bazooka" stimulus to the economy that will get people excited about Chinese equities, and wanting to invest again."

Looking through a sharper lens

And actually, he said the West needs to address its structural issues with far more urgency. "From here in Asia, we can see that the US economy faces huge structural changes, which are not being addressed, and the party parties on, whereas they should be addressing these issues structurally," he commented. "But nobody will take the risk, because if they tackle these issues head-on, it could lead to slower growth and political challenges.

"However, China's leadership acknowledges their structural challenges," he stated. "They want to try to revive the economy but not reverse policies in terms of structural change. In short, I think that is a realistic approach, but it requires more patience for investors to support that approach, while Western investors want more of the 'bazooka' approach."

Seeing China's realities

His thesis was, therefore, that Western investors need to see China through a China lens and appreciate the overall direction of travel in China. The idea is that would help them become more comfortable with the outlook, and then invest again more astutely and with a longer-term perspective, and not look at China just as a margin play for a quick bounce and rapid gain.

"The bottom line for us in terms of our advice to clients is, China is cheap, you should not take it off your radar screen," he explained. "We're not sure the big catalyst will come, but it could come from a number of small support measures and advances for the economy, as opposed to an overnight announcement of a massive spending plan."

Objectivity and empathy

He also counselled investors to take a more positive view of China's apparent problems, including the ongoing deflationary environment. "I accept that situation and take the positives from it at this time from an investment perspective because all the negatives are already fully priced into the low valuations in the market," he observed. "There are actually good reasons why we have seen deflation, and there are good reasons to believe inflation of some sort could return there. And we think Western investors should be far more worried about the major challenges relating to inflation and debt in their own economies.

Closing words – the jury is still out on China, but watch out for larger, more emphatic government-led measures and packages that would bolster structural policy support and act as a trigger for a major shorter-term boost to valuations

An expert raised a concern that, in the past, China has been seen through rose-tinted glasses. "Today, on a valuation basis, even at these low levels, on a long-term risk-return perspective, you could well argue that there are better places to put in," she commented. "Nevertheless, there are times when investors can get in and achieve good returns. For example, if there were to be a stimulus package like back in 2008, even though we do not see the political will right now; it is more focused and targeted support."

A guest added that when China's markets do rise, almost everything goes up. "But for now, we seek only selective and more resilient sectors and trades," he said. "More broadly, Asia remains a prime space for investing, with markets such as Indonesia, India, and Japan very interesting, and we like to focus where there are structural and other tailwinds. That is not China at the moment, other than selectively."

"The strategy for investing in China must be flexible," another expert said, closing the debate. "We are recommending that clients look for structural and bottom-up opportunities in China. They need to follow companies that could benefit from policy tailwinds, and also companies and industries that have comparative advantages, such as the EV value chain, cybersecurity, chips, high-end and innovative manufacturing. And we like dividend yield plays because these companies can provide investors with some protection, with our focus on SOE names that are restructuring and reforming, such as telecommunications stocks, where there are ongoing improvements in efficiency, corporate governance and also investor communications in the recent few years."

WHAT SECTORS IN CHINA WOULD YOU ADVISE CLIENTS TO INVEST IN?

- **EVs/Batteries**
- **Consumer spending/discretionary**
- **AI/Big Tech/Data**
- **TMT**
- **Financials and Insurance**
- **Healthcare**
- **High Dividend yield stocks (eg telecommunications)**
- **Oil**

Looking through the fog

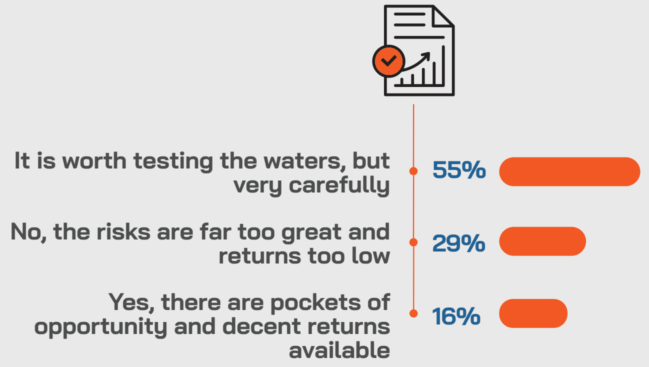
"For the savvy investor who has a deeper understanding of China, they are still going to see a vast economy that still enjoys some significant drivers of growth, and they will still seek out access points to participate in key themes," an expert reported. "These themes could be the solar and the green dream, as we can call it, or batteries of the future, or EVs, and other new technologies. China is a global champion in some of these key sectors, and you will struggle to find that type of dominance elsewhere around the world."

He observed that people bought the tech sector so heavily in the US market because the US could first take that technology in its huge economy and then they could build out their proposition globally with massive economies of scale. "And that model, that evolution could well play out in China, which in some major sectors fur the future has the technologies and the know-how to drive that next phase of global growth," he commented. "China has some companies which are ultra-competitive on the global stage."

On balance, opportunities abound

He argued that there is clearly a risk of investors missing out. "China is very evidently cheap, and if you are an EM investment manager, you are likely worried about your positioning in China, because you know it's so cheap. The day that there is a rebound, you're short, and you're going to show massive underperformance. That means we expect some short covering within the next three to six months probably; well, the timing is not clear, but it surely will come. In short, over the next 12 months, I think China could surprise us in terms of its absolute returns."

GIVEN RECENT EVENTS IN THE PROPERTY SECTOR AND IN LIGHT OF CHINA'S OVERALL DEBT TO GDP NUMBERS, SHOULD PRIVATE CLIENTS BE TAKING EXPOSURES TO CHINA'S FIXED-INCOME MARKETS (ONSHORE OR OFFSHORE DEBT)?



China still has some solid appeals

This panellist drew his comments towards a close by noting that within the EM universe, China, in his view, holds out the potential for upside and that there will be incremental advances in good news and participation and market performance. He said even the biggest bulls in India might feel that the market there has gone too far and will be looking around for alternatives ahead.

"People are sitting there saying they have cash to invest and wondering how to reallocate for 2024, and if China can navigate its way to providing people with a good sheet of potential positives, or at least a stabilisation situation, I think people will enjoy some upside," he stated. "Right now, it could be too big and too cheap to ignore."

Be brave, there is upside

His final word was that he still sticks to his view that over 12 months, investors can be brave enough to buy Chinese equities, but he noted that there are also those valid alternatives out there that might achieve good results with less direct Chinese linkages.

"You can participate in ways that might not appear so obvious," he said. "For example, investors could buy luxury goods companies that benefit from reinvigorated Chinese travel and consumer spending. They could look at the commodity sector and buy some Australian mining companies that will benefit from the good news that will emerge from China."

And there is a hedge in that approach, he added, as they are buying relatively safe stocks through participating in developed market plays on a potential rebound in Chinese demand. "But as I said and looking at the current valuations, I am a believer in the direct route as well," he concluded. ■