China equities checklist:
8 reasons to stay invested

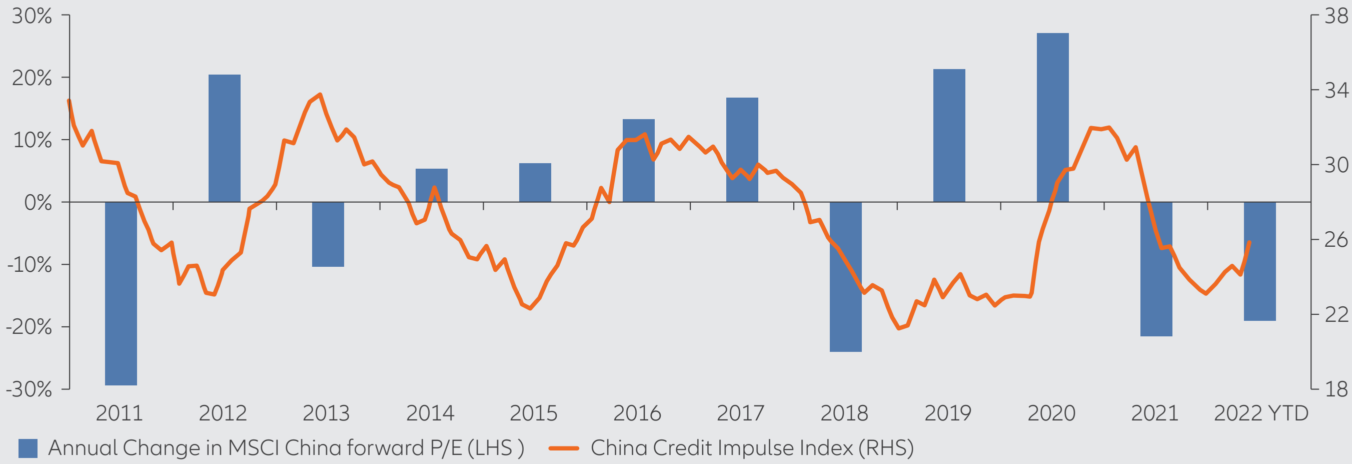
June 2022

China's zero-Covid approach and regulatory challenges have unsettled markets, but we don't think they alter the long-term investment case. Renewed government policy support and a commitment to a high-tech, carbon-free economic future should encourage long-term investors to take a fresh look at China.

1 Equities set to potentially benefit from pro-growth policies and a more stable backdrop

Many investors have been nervously watching the volatility in Chinese equity markets, and their worries are understandable. But these ups and downs seem to be because of a few macroeconomic and geopolitical issues that appear unlikely to derail the long-term investment case for China. The economy may have slowed since mid-2021, but recently there has been a clear pivot to policy aimed at supporting economic growth. We expect that support to gain traction in the coming months. China equities typically track domestic liquidity closely, with potentially improved stock market performance following periods of increased access to credit. With the China Credit Impulse Index, which measures the credit cycle in the market, already picking up in 2022, we anticipate more stable market conditions as the economy is lifted by greater government spending and the outlook for corporate earnings improves. At the same time, an expected easing of some of the more restrictive Covid-19 measures should allow the benefits of policy easing to come through.

Exhibit 1: China Credit Impulse Index and MSCI China forward price to earnings ratio change

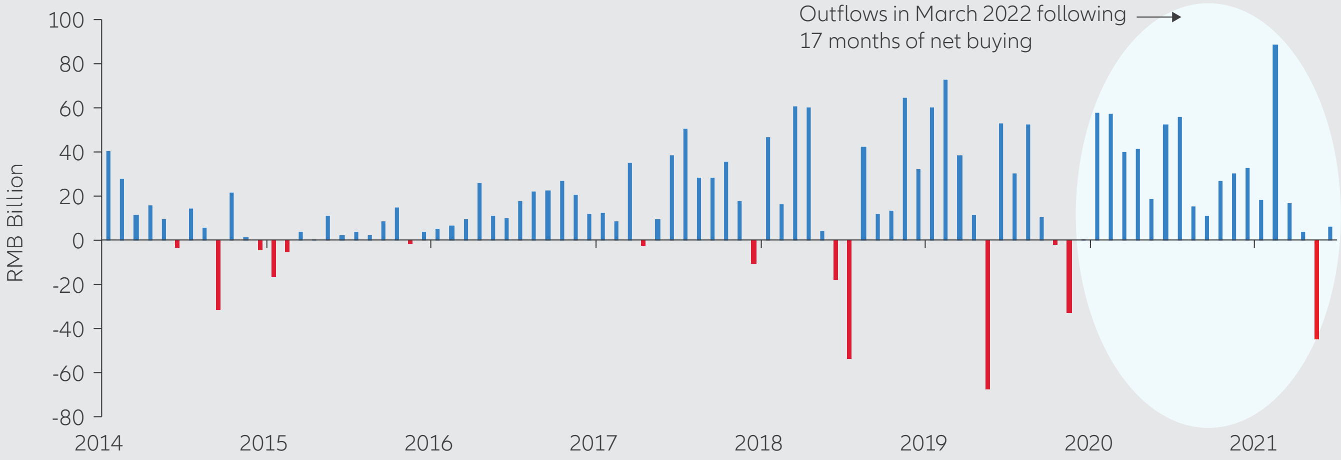


Source: Allianz Global Investors, Bloomberg. Data as at 31 March 2022. Investors cannot invest directly in an index.

Appreciating China

Allianz Global Investors

Exhibit 2: monthly northbound net buying via Stock Connect since 2014 (in RMB bn)



Source: Wind, Allianz Global Investors. Data as at 30 April 2022.

2 Long-term trend of foreign investors buying China equities intact

Despite the negative news out of China, global investors have continued to add China A-shares (stocks of Chinese companies listed on exchanges in Shanghai or Shenzhen) to their portfolios. March 2022 marked the first instance of net selling in 17 consecutive months. The Chinese government helped lay the groundwork for greater cross-border investment with the launch of the Shanghai and Shenzhen Stock Connect schemes in 2014 and 2016, respectively:

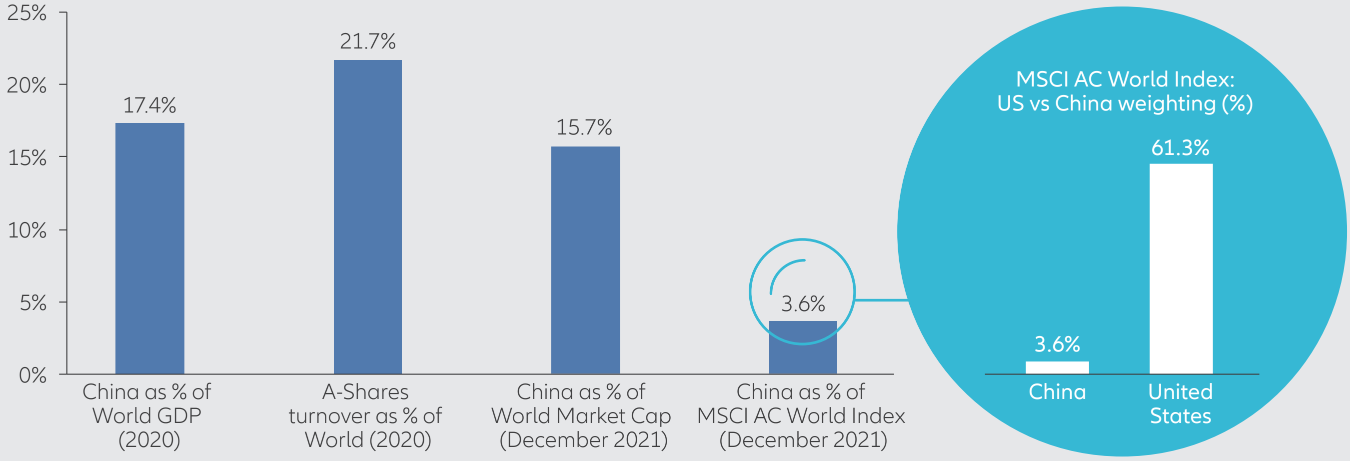
- In "southbound" trades, mainland China residents use the Shanghai or Shenzhen exchanges to buy Hong Kong-listed stocks.
- Investors outside of mainland China can use the Hong Kong exchange to buy A-shares in Shanghai or Shenzhen (known as a "northbound" trade).

China is expected to stay committed to further opening its markets to foreign investment in the coming years.

3 China's potential is not captured in world equity indices

Despite China's growth and ambitions, we believe its significant economic potential is not fully reflected in global equity indices. Indeed, a key reason for the long-term trend of global investors adding to China A-shares is because of the relative mismatch between the historically low level of portfolio allocations and China's economic clout and market scale. As at 31 December 2021, the MSCI AC World Index had a 61.3% allocation to the United States and just a 3.6% allocation to China. As China's capital markets become increasingly integrated into the global financial system, we believe this gap should narrow. And over time we expect global investor allocations to China should continue to increase, in line with China's growing economic influence.

Exhibit 3: key statistics on China and China equities



Source: FactSet, MSCI, Goldman Sachs Global Investment Research. Data as at 31 December 2021. Investors cannot invest directly in an index.

4 Chinese stocks don't move in lockstep with other equity markets

China's equity markets can be useful as a portfolio-diversification tool. A-shares have a correlation of 0.31 with global equities over the last 10 years, which means they move in different directions almost 70% of the time. In comparison, US and global equities have a correlation of 0.97. Therefore, holding China A-shares in a global portfolio may help generate a better overall risk return profile.

Exhibit 4: historical correlation between major equity markets since 2012

	China A-shares	HK-listed China stocks	APxJ equities	GEM equities	Japan equities	US equities	European equities	World equities
China A-shares	1.00	0.59	0.46	0.44	0.25	0.29	0.27	0.31
HK-listed China stocks	0.59	1.00	0.85	0.84	0.50	0.48	0.54	0.56
APxJ equities	0.46	0.85	1.00	0.97	0.58	0.69	0.70	0.78
GEM equities	0.44	0.84	0.97	1.00	0.55	0.68	0.71	0.77
Japan equities	0.25	0.50	0.58	0.55	1.00	0.58	0.67	0.66
US equities	0.29	0.48	0.69	0.68	0.58	1.00	0.78	0.97
European equities	0.27	0.54	0.70	0.71	0.67	0.78	1.00	0.86
World equities	0.31	0.56	0.78	0.77	0.66	0.97	0.86	1.00

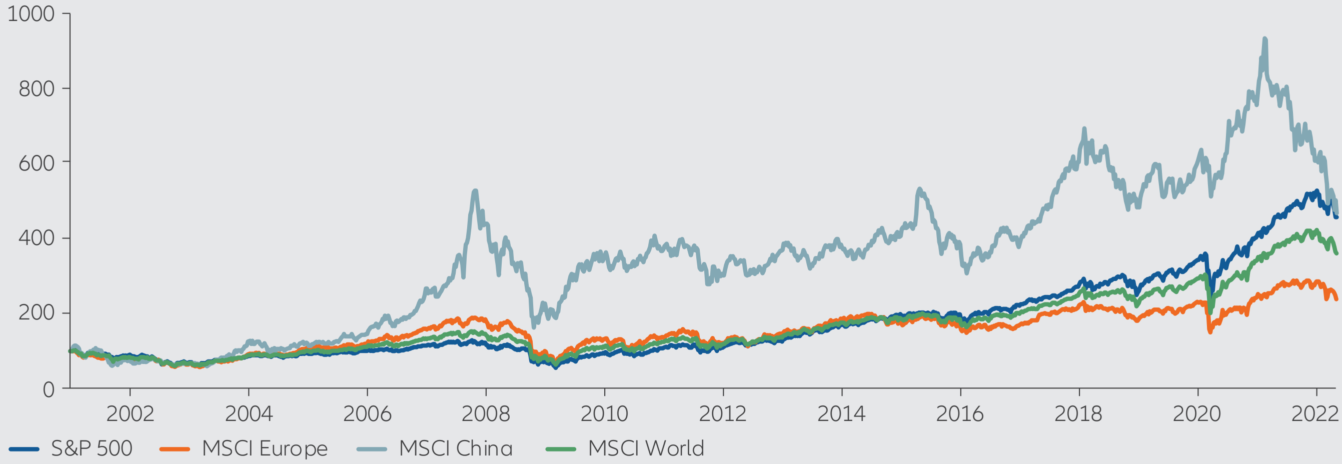
■ Low correlation ■ High correlation

Source: Bloomberg, Allianz Global Investors. Data as at 30 April 2022. Correlation data is calculated based on historical return of respective MSCI indices for the past 10 years, using weekly USD return. China A-shares represented by MSCI China A Onshore Index; HK-listed China stocks by Hang Seng Chinese Enterprises Index; APxJ equities by MSCI AC Asia ex Japan Index; global emerging market equities by MSCI Emerging Markets Index; Japan equities by TOPIX Index; US equities by S&P 500 Index; European equities by MSCI Europe Index; world equities by MSCI World Index. Past performance is not indicative of future performance. Investors cannot invest directly in an index. Diversification does not guarantee a profit or protect against losses.

5 China equities exhibit higher volatility – and potentially higher returns over the longer-term

Investing in China brings different risks and greater unpredictability compared with Western markets. The Chinese government's clampdown on the internet platform and property sectors in 2021 – and the subsequent economic slowdown – illustrate this point. But investors have historically been rewarded with long-term outperformance. Hypothetically, an investment in the MSCI China Index in the period from the end of 2000 to 30 April 2022 would have generated a 418% return in US dollar terms, more than double the return from European equities (MSCI Europe Index). In the past, moments of volatility like those seen recently have proved to be buying opportunities for many long-term investors.

Exhibit 5: MSCI China, MSCI ACWI, MSCI Europe and S&P 500 performance since 2001 (in USD, indexed to 100)

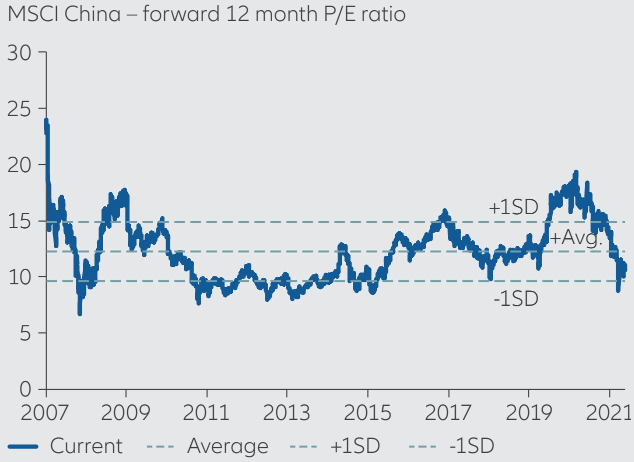


Source: Reuters Datastream, Allianz Global Investors. Data as at 30 April 2022. Based on total return performance in gross, in USD. Past performance is not indicative of future results. Investors cannot invest directly in an index.

6 Attractive valuations

Chinese equities, both onshore China A-shares and offshore stocks listed in Hong Kong, are trading at valuations below the historical average. That suggests much of the negative news surrounding the economic slowdown is already priced in. Within the market, we see the pullback in recent months as a buying opportunity on a longer-term perspective for a growing number of high-quality stocks.

Exhibit 6: MSCI China A Onshore and MSCI China forward 12-month P/E

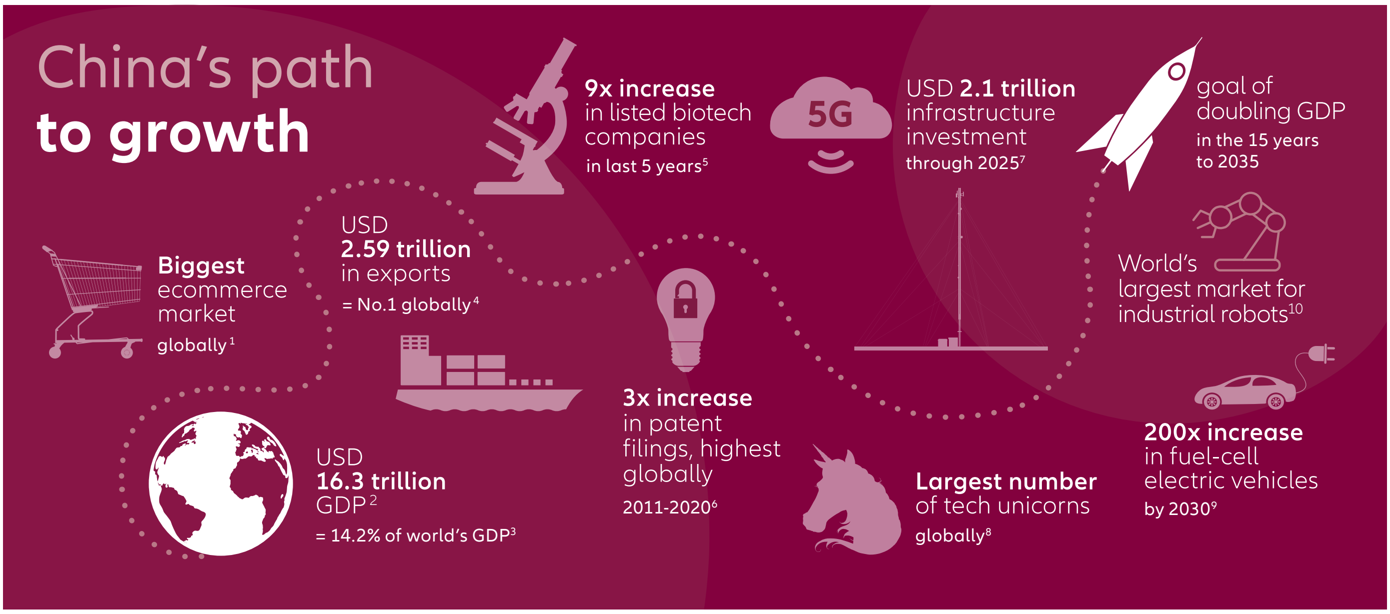


Source: Bloomberg, Allianz Global Investors, as of 30 April, 2022.

7 Innovation and transformation: key drivers of China's growth

China has come a long way in a short time. Once known as the "factory of the world", it has shifted away from low-cost manufacturing towards the high-tech areas that are essential to its growth – and self-sufficiency. China is seeking to increase its level of self-sufficiency in critical technologies of the future such as semiconductors and other strategically important areas like domestic energy supply. A rapidly expanding middle class, increasing domestic consumption and high-tech innovation are all key ingredients of the China growth story.

Exhibit 7: China's path to growth



1. Source: eMarketer. Data as at 2020.
2. Source: World Bank. Data as at 2019.
3. Source: World Bank. Data as at 2019.
4. Source: World's Top Exports. Data as at 2019.
5. Source: McKinsey, as at July 2021.
6. Source: WIPO, Allianz Global Investors, as at end 2020.
7. Source: Goldman Sachs. Data as at July 2020.
8. Source: Hurun Research Institute, Nikkei Asia review. Data as at 2019.
9. Source: Belfer Center for Science & International Affairs.
10. Source: International Federation of Robotics, as at January 2022.

8 China's equity market offers multiple options for investment

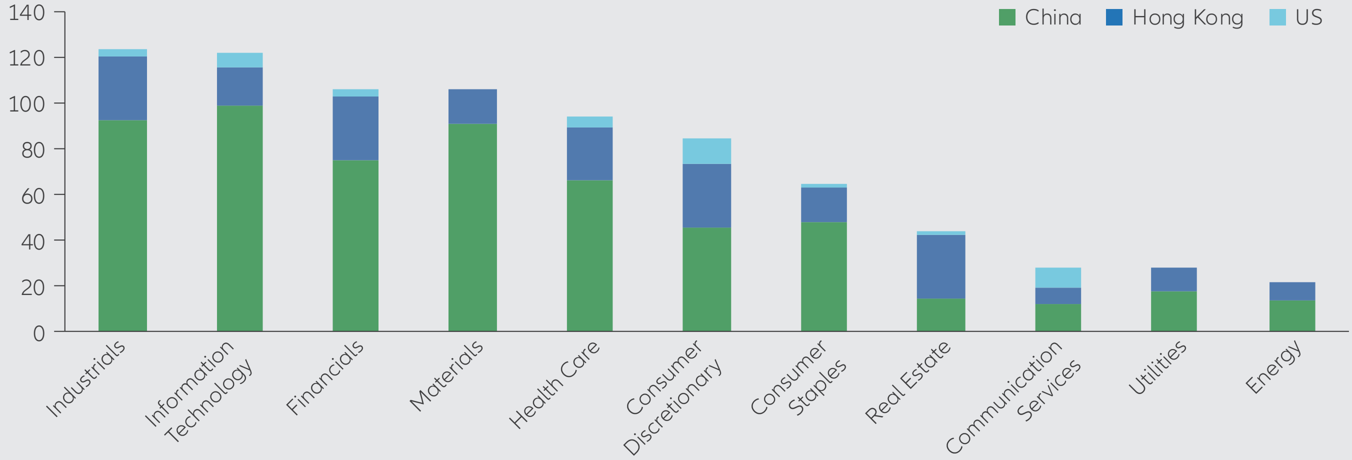
There are many ways for investors to buy shares of Chinese companies, with the capital markets much broader and deeper than many investors realise. This has become even more important during China's recent regulatory clampdown, which impacted some listings more than others – particularly US-listed American depositary receipts (ADRs) and select Hong Kong-listed companies. Investors also have access to a diversified range of sectors. Structural growth areas such as industrials, technology and materials are concentrated onshore, while internet and other traditional sectors such as real estate, utilities and energy are better represented in the offshore space. The multiple ways to invest and diversity in sectors are among the reasons why Chinese equities may provide an attractive investment option.

Exhibit 8: major stock exchanges for China equities vs euro area

	Shenzhen A-shares	Shanghai A-shares	China stocks listed in HK	US-listed ADRs	Total	Euro area
Market cap (USD tn)	5.2	7.2	3.9	0.9	17.2	9.7
Number of stocks	2,619	2,074	1,371	151	6,215	3,686

Source: Shenzhen Stock Exchange, Shanghai Stock Exchange, Hong Kong Stock Exchange, Bloomberg, Allianz Global Investors. Data as at 31 March 2022. The total figures are for comparison only. The stocks included may be listed in more than one exchange. Offshore China stocks are defined based on companies with ultimate parent domiciled in China. Suspended stocks, investment funds and unit trusts are excluded.

Exhibit 9: MSCI China All Shares Index – number of stocks by listing location



Source: Bloomberg, Allianz Global Investors. Data as at 30 April 2022. The total figures are for comparison only.

MSCI AC Asia ex Japan Index is an unmanaged index that captures large- and mid-cap representation across two developed-market countries (excluding Japan) and nine emerging-market countries in Asia. MSCI All Country World Index (ACWI) is an unmanaged index designed to represent performance of large- and mid-cap stocks across 23 developed and 24 emerging markets. MSCI China A Onshore Index is an unmanaged index that captures large- and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. MSCI China Index is an unmanaged index that captures large- and mid-cap representation across approximately 85% of the China equity universe. MSCI Emerging Markets Index is an unmanaged index that captures large- and mid-cap representation across 27 emerging-market countries. MSCI Europe Index is an unmanaged index that represents the performance of large and mid-cap equities across 15 developed countries in Europe. MSCI World Index is an unmanaged index that captures large- and mid-cap representation across 23 developed-market countries. Hang Seng Chinese Enterprises Index is an unmanaged, market capitalisation-weighted index tracks the performance of major H-shares (stocks traded on the Hong Kong exchange). Standard & Poor's 500 Composite Index (S&P 500) is an unmanaged index that is generally representative of the US stock market. TOPIX Index is an unmanaged, market capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. Investors cannot invest directly in an index.