Best Perspective

Following a sharp decline in share prices, Chinese A shares are cheaper than ever. The potential is as great as before.

That's a word: the equivalent of 63 billion euros for the banking system. Even the US and the European Union (EU) would have to stretch for that. China, on the other hand, seems to be showing support for the financial sector and thus the economy. It gets better: 170 billion euros for infrastructure as a stimulus package. Around the globe, such numbers are bringing tears to the finance ministers of even the largest economies. Probably also to the Finance Minister in the Middle Kingdom, Liu Kun. China seems to be able to afford it - and it can too. Due to the weakest growth rate of the economy in the second quarter of 2018 for two years - but at least 6.7% - Beijing relaxes financial controls. "It is a concrete sign of coordinated incentive and targets key factors that have weighed on Chinese markets," said Aidan Yab, economist at Axa Investment Asia in Hong Kong. Especially for the stock market players in Shanghai, Shenzhen and Hong Kong, this means good news. After all, investor confidence has waned in the past few months. After the slump of about 20% on China's stock exchanges, however, there are now very favorable entry prices for long-term oriented investors. Getting started is easy with the right ETFs.

More mobs than action. In the short to medium term, even the Damocles sword of shattered trade relations with the US is hanging over the Chinese stock market. Volatility should therefore remain high. What US President Donald Trump is actually doing about his threats remains to be seen. Since there would be only losers in a trade war, it can be assumed that both parties will again sit at the negotiating table. However, it is clear that Trump will make concessions, as the trade deficit with China in June was relatively high at just under $ 29 billion. On the other hand, the Chinese economy is by far not as dependent on exports as it was just ten years ago, so Beijing does not have to bow down to all US demands. In addition, many US corporations that relocated or transferred parts of their production bases to China would also be burdened.

In the likely case of mild tariffs, the burden for China is relatively low. The Ifo Institute assumes that the already introduced 25% punitive tariffs on aluminum and steel only mean a loss of about € 237 million for China. If the US extends the duty on cars, it would be almost € 1.7 billion damage, which would only reduce the Chinese gross domestic product (GDP) by 0.02%.

Therefore, Beijing is not panicking on these monetary and fiscal stakes, but, as usual in China's leadership, moves are well-considered and well-structured. For example, the € 63 billion that have been handed over to the banking sector for a year are earmarked, in so far as the Chinese credit institutions, to buy corporate bonds. This will improve the financing situation in the corporate sector accordingly. The new infrastructure injection again will be administered in the form of a special bond. This should be able to better finance local government projects. To emphasis Beijing’s interest in building infrastructure in lagging areas, Prime Minister Li Keqiang recently visited infrastructure projects in Tibet.

In addition, there will be tax relief for SMEs in particular. This should in turn strengthen consumption. From October 2018, a new tax law provides for the private income exemption limit to rise from (converted) around €5400 to €7750. In addition, expenditure for some goods and services such as the education of children, rents and mortgage rates as well as the treatment of serious illnesses are at least partially tax deductible. The increased consumption could offset the lack of investment due to trade conflict uncertainties.

Currency not used as a weapon. The current weakness of the Chinese yuan may be a welcome aid to the Beijing government in the near term, to help alleviate the negative effects of the trade dispute. The yuan lost over 9% of its value versus the US dollar since April. Washington suspects a targeted weakening of the Chinese currency by Beijing. But this is not the case, according to a study by the financial information service Bloomberg. The Bloomberg model shows that the Yuan moves have followed market signals. Internal and external stress factors are currently weakening the yuan. The People's Bank of China (PBOC), the China's central bank, therefore, even backed the yuan in early August by installing a 20% reserve requirement on financial institutions for foreign exchange transactions. This makes it more expensive to bet on a falling Chinese currency. Already in 2015, when there was a wave of capital flight, this central bank applied medicine proved its worth. After the market saw that the PBOC does not want the currency to slide, the yuan has stabilized.

The action of the PBOC gives the impression that China has its financial markets firmly under control. But this cannot cover up that the Middle Kingdom - and its financial markets – is opening up to foreigners. Hence the stock exchanges of the country should receive enormous support. Simon Lee of asset manager CSOP in Hong Kong expects that China's financial industry in particular will benefit enormously from opening up the country to foreign investors. For example, in the future, foreigners will be able to own up to 51% of insurance companies, fund companies and securities dealers. Lee assumes that in a few years this limit will disappear altogether. "This is a great opportunity for foreign financial service providers. But above all, it's a great prospect for the Chinese financial industry, " explains the market insider. Lee relies on past experience. In most cases, the market opening of one sector is more dynamics and growth led. The CSOP expert is sure that the new competition from experienced foreign players will drive the Chinese financial service providers to more efficiency and inspire business. Lee's view is shared by other analysts. Experts at Bloomberg Intelligence, for example, predict that Chinese banks' profits will double by 2025.

Industry before boom. Therefore, investing in the Chinese financial industry could be a good idea for long-term investors. As banks and insurance companies have a large share of the index weightings, a positive development of this sector should also have a positive effect on the overall index. As long as the trade disputes do not escalate, the economy as a whole may not be as bad as some fear. Although it is true that indebtedness of many companies has grown by an order of magnitude that requires countermeasures from Beijing. These stricter lending restrictions should succeed as long as economic growth remains high. However, the leading indicators of the national economy indicate a weakening of the economy. The Purchasing Managers' Index, a recognized economic barometer, has dropped from 54.4 to 53.6 points in July versus June. But a value above 50 continues to indicate growth. According to a survey of news service provider Bloomberg among 62 economists, experts expect for the current year on average, economic growth of 6.6%. Expectations for a Chinese recession have fallen from 13% in June to 10% in July. The foundation for a recovery on the Chinese stock exchanges seems to be in place, allowing investors to participate in low-cost ETFs (see next piece).

China A-share ETFs – Always better Funds

There are now more than a dozen China ETFs listed on the German Stock Exchange. However, most of these funds only include stocks that are traded in Hong Kong or other non-Mainland Chinese exchanges. These index funds include, among others, all ETFs that track the MSCI China Index. However, ETFs with the so-called A-shares are on the rise. A-Shares are securities of Chinese companies listed on the Shanghai and Shenzhen Stock Exchanges and traded in renminbi, the Chinese currency.

X-trackers was a pioneer in China A-share ETFs. This former ETF unit of Deutsche Bank, has since merged into DWS – Deutsche Bank's listed fund subsidiary. Back in July 2012, an X-trackers ETF debuted on the CSI 300 index. This first AA equity ETF synthetically replicated the index with the help of swaps. However, there are now physically replicating A-share ETFs available that actually hold the corresponding A-shares in the portfolio. The European ETF providers work mostly with Chinese investment firms that are required to buy the A-shares. For example, X-trackers is partnering with broker Harvest on its Harvest CSI 300 Index ETF. US fund issuer Invesco is working on its CSOP Source FTSE China A50 ETF with CSOP Asset Management from Hong Kong.

The A-share ETFs differ mainly in terms of the number of shares they hold. The most focused is the CSOP Source FTSE China A50 ETF. This ETF contains only the 50 largest by market capitalization Chinese companies listed on the stock exchanges in Shanghai and Shenzhen. The X-trackers Harvest CSI 300 Index ETF, on the other hand, invests in the 300 largest A shares, just like its synthetic predecessor. Even wider is the spectrum of the iShares MSCI China A ETF and the Legal & General E Fund MSCI China A ETF. Both these funds track the evolution of the MSCI China A Index. This index comprises 460 A-shares.

Given these different designs, it is therefore important to have a close look into the portfolio of the ETF before making an investment. Depending on the market assessment and personal investment goals, we can recommend some funds. Whoever wants to take advantage of the emerging opportunities in the Chinese financial sector, is well served by the CSOP Source FTSE China A50 ETF. This ETF contains nearly 60% financial stocks. In the ETFs on the MSCI A-share index, financial institutions are only one-third of the portfolio. The MSCI index contains nearly 8% technology stocks, which are virtually non-existent in the FTSE A50.

An interesting alternative to the mentioned ETFs is the brand new Market Access Stoxx China A Minimum Variance ETF. In this innovative ETF, A-shares are weighted not by their market capitalization but by their volatility. The lower the price fluctuations, the higher the weight of the A-share. The goal is to reduce the volatility of the ETF. The index underlying this ETF was developed together with the index provider Stoxx and currently consists of 135 shares listed on the Shanghai and Shenzhen exchanges. The issuer of the ETF is China Post Global based in Hong Kong and London, which is the international asset management branch of China Post Fund, one of the largest asset managers in China. "The ETF targets investors who have previously invested in the often volatile A-shares," explains Danny Dolan, Managing Director of China Post Global in London. Incidentally, the new ETF uses China's Stock Connect program, which trades shares listed in Shanghai and Shenzhen via the Hong Kong Stock Exchange. This Hong Kong detour reduces foreigners' trading restrictions on Chinese equities.

“Significantly more return”

Interview with Danny Dolan - Managing Director of China Post Global in London.
A new smart beta ETF for Chinese A-shares promises investors more return with less risk

His firm recently launched the first smart beta ETF for Chinese equities. What is the strategy of this ETF?
The Market Access Stoxx China A Minimum Variance Index ETF aims to provide European investors with a low-volatility investment in Chinese mainland stocks, i.e. the so-called A-shares traded on the Shanghai and Shenzhen Stock Exchanges. Although many investors want to invest in China, so far they have been deterred because they are worried about volatility. The strategy of the ETF aims to remove volatility and to take as much as possible of the price increase in strong stock market phases, but to lose less than the market when the price falls. The bottom line is that the ETF should offer investors a better risk-return ratio than an ETF on broad indexes such as CSI 300 or MSCI China A.

How do you achieve this goal?
The ETF tracks an index developed in collaboration with the index provider Stoxx. Stoxx is also responsible for stock selection and index calculation. The portfolio contains around 150 A-shares. In fact, the ETF portfolio only has liquid shares that can be used to assemble a portfolio with the lowest possible volatility. The universe from which Stoxx selects stocks is the Stoxx China A 900 Index.

Are certain industries particularly dominant or strongly represented in this novel ETF?
The composition of the ETF portfolio differs significantly from indices such as the CSI 300. In our Minimum Variance Index ETF, technology stocks and especially financials are much less weighted. Instead, our ETF currently has a relatively high weighting in consumer stocks, accounting for around 40%.

Doesn’t this high weighting of consumer stocks tend to mean lower returns?
That is not mandatory. On the contrary: so far, the high proportion of consumers has been a great advantage. The ETF index has been calculated since the beginning of 2017 and since then has delivered significantly higher returns than the CSI 300 index, both in the uptrend and in the recent price decline - despite lower price fluctuations.

Which fund company is behind the ETF?
We offer the China A Minimum Variance ETF in Europe under the brand name Market Access. This ETF was launched by China Post Global, an asset manager based in Hong Kong and London. China Post Global is the international arm of China Post Fund, a Chinese asset manager founded in 2006, which currently offers around 50 investment funds in China. In 2016, China Post Global acquired the Royal Bank of Scotland's ETFs, Market Access, as well as the bank's ETF team.

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