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MSCI A SHARE INCLUSION: KEY AREAS TO WATCH

China A-shares give global investors a more accurate representation of the opportunities within China. While a strong source of alpha for stock pickers, A-share companies will need to have stronger environmental stewardship going forward. Increased internationalisation over the longer term will also help China's markets realise the true potential they offer.

Despite being the second biggest economy in the world, with a total market capitalisation of more than USD8.5 trillion, Chinese stocks are under-represented in investor portfolios. This is due to local regulations preventing most global investors from having direct access to China's A-share equity markets. This has changed with the inclusion of 235 A-share stocks on 1 June 2018, accounting for 2.5% of the MSCI China Index. MSCI will lift the weighting of A-shares in the index to 5% by August 2018.

Even though the initial Chinese A-share stock weighting is minimal, we expect this to change gradually as China opens its stock markets through the continuing developments of the Stock Connect Programme between the Hong Kong Stock Exchange and the Shanghai as well as Shenzhen Stock Exchanges.

The mainland-listed Chinese companies provide a different investment perspective. They form a more accurate representation of the actual investment opportunities within China compared to the Hong Kong and US-listed Chinese companies that account for only a portion of China's economy. The MSCI inclusion also allows global investors to further diversify given the low correlation of 0.2[1] between US and A-shares over the past 10 years. The breadth of stocks available is large and given market inefficiencies, the A-share market should be a strong source of alpha for stock pickers.

ATTRACTIVE VALUATION AND BETTER THAN PERCEIVED TRACK RECORD

In the short-term, trade tensions between the US and China might continue to escalate and create volatility in the market, which combined with rising defaults and rising rates - albeit from a very low base for both - might bring some buying opportunities.

At the corporate level, Chinese A-share companies recorded double-digit earnings growth for the first time in 2017 amid a resilient pick up in the economy. Well-run Chinese businesses are able to take advantage of the country's economic transformation to produce positive earnings results. This could further translate into better profitability, more positive free cash flow generation and strengthen the case for an increase in dividend payouts - all important attributes for investors. Market valuations look reasonably attractive at 12.6x[2] 2018 earnings, in line with the valuation of the MSCI Emerging Markets Index.

EMBRACING ESG PRINCIPLES

China needs to embrace environmental and social governance (ESG) principles as outlined by the United Nations-supported Principles for Responsible Investment (UN PRI). With the growing number of asset owners and managers implementing UN PRI principles, it is very important for China to support further corporate reforms in this area as well as provide resources for companies to learn about how to incorporate sustainability into their business models.

According to MSCI, about 86%[3] of the constituents of the MSCI China A International Index currently fall below BBB, the mid point for MSCI ESG ratings.

The outlook appears optimistic - the Chinese authorities are shifting away from a resource-intensive, infrastructure-based economy to one that is service and technology focused. President Xi had also affirmed China's commitment to green development at the 19th Party Congress in October last year. It is, however, likely to take time for Chinese companies to fully embrace an ESG framework.

FURTHER OPENESS

Investors will want to understand the long-term plan to further open the Chinese markets, including currency covertibility. Given the importance of China to the world economy and geopolitical frameworks, it is essential that momentum toward liberalisation continues so China can realise the true potential that its capital markets can offer.

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[1]Bloomberg, as at 18 June 2018. [2]CSI 300 Index. Bloomberg, as at 18 June 2018. [3]MSCI Inc – Can China A Share issuers adapt to ESG realities? As at June 2018.

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