7 reasons to stay invested in China equities

September 2021

Although recent news out of China has understandably unsettled the markets, we don't think it changes the long-term investment case. Volatility goes hand in hand with China's higher long-term return potential. Understanding the dynamics at play can help make these changes easier to take in stride.

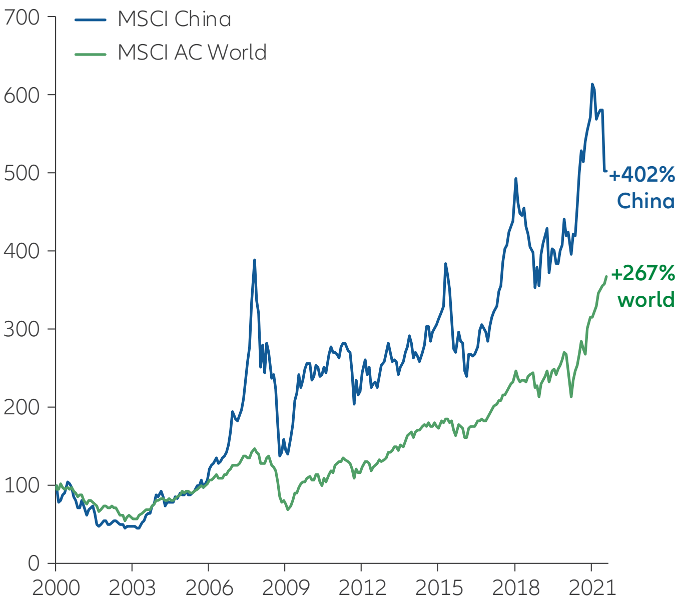
1 China equities have always exhibited higher volatility – and attractive returns

Investing in China brings different risks and greater unpredictability compared with Western markets. The Chinese government's recent clampdown on tech firms and education companies illustrates this point. But investors have historically been rewarded with long-term outperformance. Indeed, as **Exhibit 1** shows, an investment in the MSCI China Index from January 2000 to the end of August 2021 would have generated a 402% return. In the past, moments of volatility like this have proved to be buying opportunities for many long-term investors.

2 The US and EU were already focused on regulating big tech

There are many ways for investors to buy shares of Chinese companies. This has become even more important during China's recent regulatory clampdown, which affected some listings – particularly US-listed American depositary receipts (ADRs) and select Hong Kong-listed companies – more than others. With China A-shares constituting almost 70% of China's total market capitalisation size, China's capital markets are much broader and deeper than many investors realise (see **Exhibit 2**).

Exhibit 1: MSCI China and MSCI ACWI performance since 2000 (in USD, indexed to 100)



Source: Bloomberg, Allianz Global Investors. Data as at 31 August 2021. Based on total return performance in gross, in USD. Past performance is not indicative of future results.

Exhibit 2: 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)	5.8	7.6	5.5	1.6	20.5	10.3
Number of stocks	2,455	1,974	1,341	152	5,922	3,561

Source: Shenzhen Stock Exchange, Shanghai Stock Exchange, Hong Kong Stock Exchange, Bloomberg, Allianz Global Investors. Data as at 30 June 2021. 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.

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3 China's A-shares were less affected by recent volatility

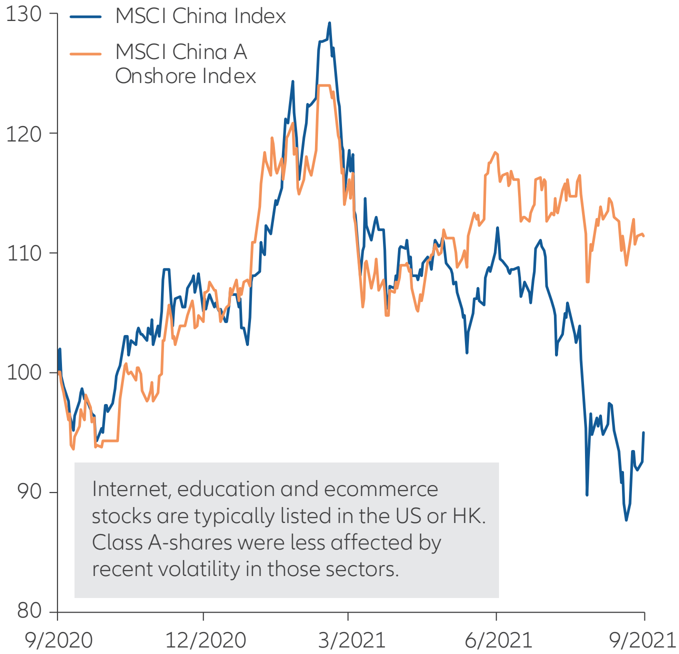
The regulatory clampdown on tech giants and education firms didn't affect China A-shares as much as other listings (see **Exhibit 3**). It's another reasons for investors to explore the broad universe of Chinese equities – regardless of where the stocks are listed.

- Internet, education and ecommerce stocks tend to be better represented in Hong Kong-listed stocks and US-listed ADRs (American depositary receipts).
- A-shares (stocks of Chinese companies listed on exchanges in Shanghai or Shenzhen) tend to feature more companies in sectors such as industrials, healthcare and consumer goods.

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

China's equity markets are appreciated for their long-term potential for outperformance, but they're also useful as a portfolio-diversification tool. As shown in **Exhibit 4**, China A-shares have a correlation of 0.32 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.) Holding A-shares in a global portfolio may help generate a better risk-return profile.

Exhibit 3: MSCI China A Onshore Index vs MSCI China Index performance since September 2020 (in USD, indexed to 100)



Source: Bloomberg, Allianz Global Investors. Data as at 31 August 2021. Based on total return performance in gross, in USD. Past performance is not indicative of future results.

Exhibit 4: historical correlation between major equity markets since 2011

	China A-shares	HK-listed China stocks	APxJ equities	GEM equities	Japan equities	US equities	European equities	World equities
China A-shares	1.00	0.61	0.47	0.45	0.24	0.3	0.3	0.32
Hong Kong-listed China stocks	0.61	1.00	0.85	0.83	0.51	0.5	0.57	0.58
Asia Pacific Ex-Japan equities	0.47	0.85	1.00	0.97	0.63	0.7	0.75	0.78
Global emerging market equities	0.45	0.83	0.97	1.00	0.6	0.69	0.77	0.78
Japan equities	0.24	0.51	0.63	0.6	1.00	0.57	0.67	0.69
US equities	0.3	0.5	0.7	0.69	0.57	1.00	0.8	0.97
European equities	0.3	0.57	0.75	0.77	0.67	0.8	1.00	0.91
World equities	0.32	0.58	0.78	0.78	0.69	0.97	0.91	1.00

■ Low correlation ■ High correlation

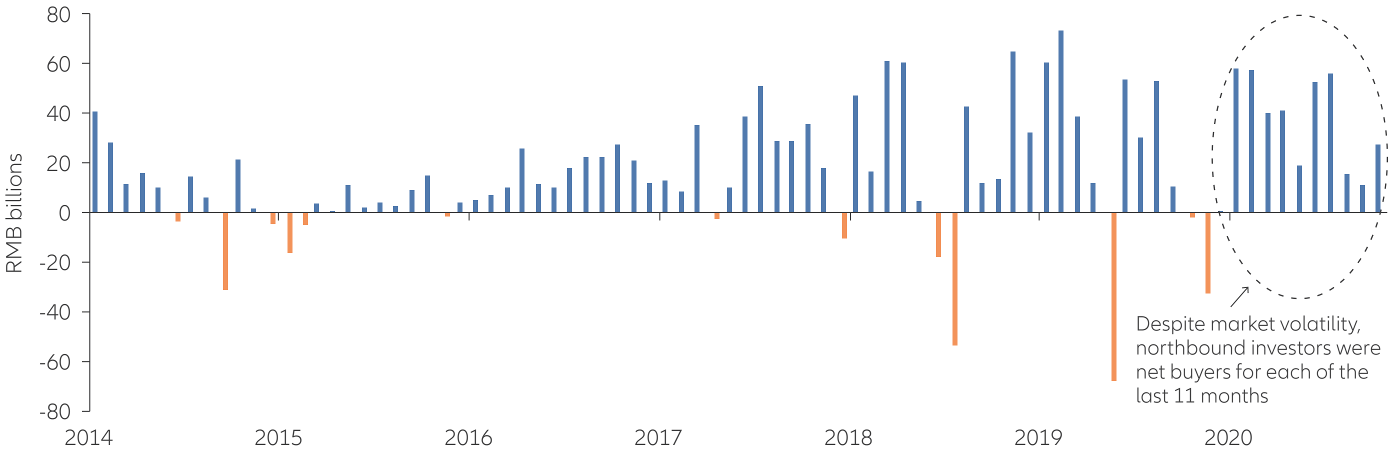
Source: Bloomberg, Allianz Global Investors. Data as at 31 August 2021. Correlation data is calculated based on historical return of respective MSCI indices for the past 10 years, using weekly USD return. China A-shares represented by MSCI China A Onshore Index; HK-listed China stocks by Hang Seng Chinese 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.

5 Foreign investors are still buying China equities, despite recent turmoil

Despite the negative news out of China, global investors have continued to add China A-shares to their portfolios (see **Exhibit 5**). August 2021 marked the ninth consecutive month of positive flows for this share class, suggesting a "buy the dip" mentality. The Chinese government recently 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).

Exhibit 5: monthly northbound net buying via Stock Connect since 2014 (in RMB)

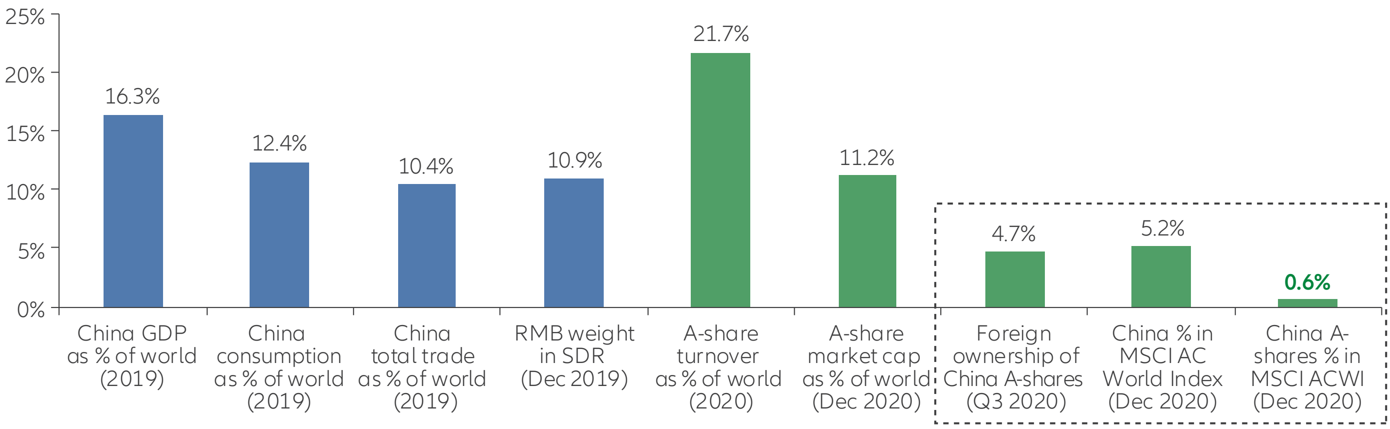


Source: Wind, Allianz Global Investors. Data as at 31 August 2021.

6 Major global indices are adding large numbers of Chinese stocks

In a sign of China's growing integration into global financial markets, major stock indices have been adding more Chinese stocks – reflecting the increasing importance of China to the global financial system. But China's representation in these indices still underplays the country's significant economic potential (see **Exhibit 6**). Investors may want to consider allocating more to China than benchmarks do.

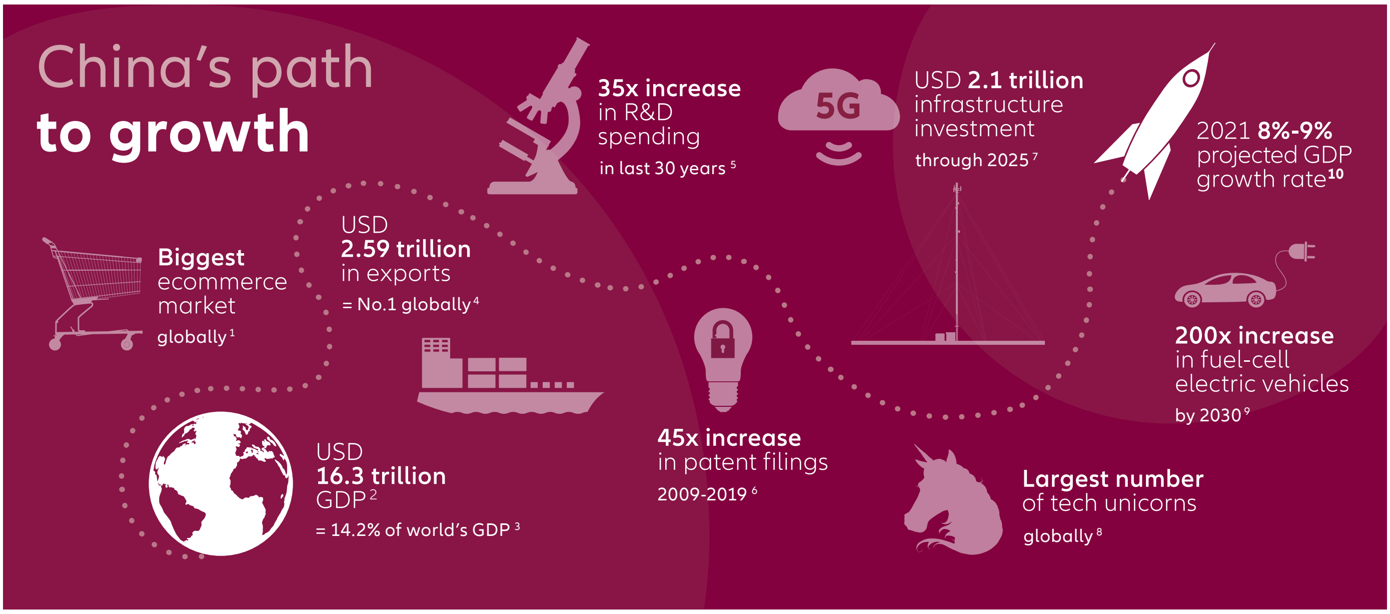
Exhibit 6: key statistics on China and China equities



Source: FactSet, MSCI, Goldman Sachs Global Investment Research. Data as at 31 December 2020.

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 shifted away from low-cost manufacturing towards the high-tech areas that are essential to its growth – and, crucially, its desire for self-sufficiency. A rapidly expanding middle class, increasing domestic consumption, high-tech innovation and a commitment to a carbon-free economy are all key parts of the China growth story.



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: OECD, Allianz Global Investors. Data as at 2018.
6. Source: World Intellectual Property Organization. Data as at December 2019.
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: IMF. Data as at 2021.

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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.