Crossbow Partners
Experience & Discipline

Singapore Trip Report

May 29 - 30, 2017

Executive Summary

The business sentiment for Asia is positive as the region is growing fast and the debt problem is currently not a concern

In 2017, China appreciated its currency against the USD in order to avoid increased pressure from the US and prevent further capital outflows

The Chinese government adjusted very quickly to the new US policy and was able to get out of the crossfire

China will re-shuffle their Politburo in October 2017 and will do anything to keep the economy strong and markets calm until then

In Japan, GDP growth is robust, wage growth is accelerating due to a labor shortage and consumption is picking up

The ASEAN region is still at an early development stage and could do very well over the coming 10 years with Vietnam as its most promising member currently

Most managers are quite cautious as some market correction is overdue, the geopolitical risks are under appreciated and the central banks will reduce their market support in due course

Chinese Stock Market Developments

On June 21st, MSCI announced the landmark decision to add 222 China A-share stocks to the MSCI EM Index on a gradual basis beginning in 2018, all of which are accessible via the Shanghai and Shenzhen - Hong Kong Stock Connect programs. This initial addition will account for 0.73% of the MSCI EM Index and helps pave the way for a substantial inclusion of the A-Shares in the Index over the mid to long-term that will force investors to re-evaluate their view and allocation to the world's second largest economy.

Snapshot of MSCI EM Index:

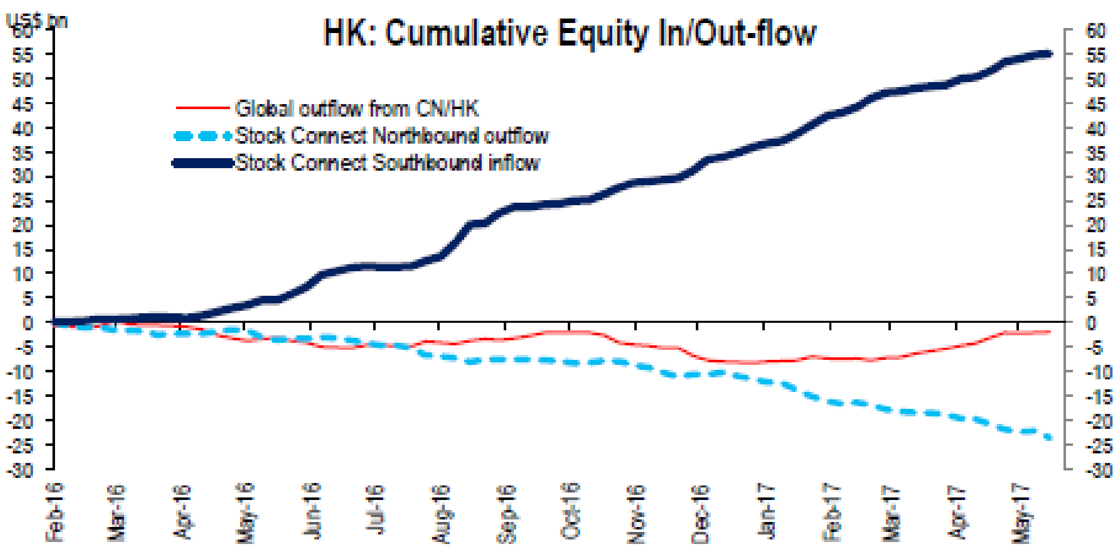
- Index funds and ETFs have over USD2 trillion benchmarked against the MSCI EM Index with Hong Kong stocks currently accounting for around 26% in the Index.
- If a full inclusion of China's A-shares were realised then Hong Kong and China combined would account for more than 45% of the Index.

What the A-share inclusion means:

- An initial USD 12-14 bn of assets is expected to flow into the MSCI EM Index with the inclusion.
- Whilst this first inclusion is small, it holds significant relevance as A-Shares could increase as a constituent to account for over 18% (or over USD 300 bn) of the Index in the next 3-5 years.
- The inclusion will help to institutionalise China's domestic markets, a move that will be welcomed by the regulators in the retail dominated markets.
- Global institutional investors, including the world's largest fund houses, have expressed their support for the inclusion and will re-evaluate their allocation to A-shares.
- The regulators will continue to adjust the QFII, RQFII and Stock Connect programs to allow greater access to the markets and ensure a steady increase to the number of constituents added to the MSCI EM Index.

The inclusion is going to fuel an ever-increasing rise in foreign investors' penetration in the China A-Shares market. It will improve the efficiency and transparency of the Chinese markets.

Market direction is often determined by the liquidity at the margin. In the HK market, it is the Southbound inflows from mainland investors this year while for the A-shares market, it is the Northbound buying of blue-chip, low valuation stocks by foreign investors in anticipation of the MSCI inclusion.



Source: Citigroup

The HSI gained 17.1% in the first half of 2017, making it one of the best performing markets globally. Although the onshore A-Shares market had very diverging performances (e.g. SSE gained only 2.9%, SZSE 3.5% and the GEM board declined 7.3%), it belied the fact that the A-Shares included in the Northbound Connect gained an average of 23%, with the top 20 stocks are up a stunning 42%.

In the HK market, Southbound Connect contributed 10.5% of HK turnover in July 2017, doubled from 5.5% a year ago. The Southbound inflow is far more significant than the global outflow. Sector wise, southbound top overweight sectors are financials and consumer discretionary, and top underweights are IT, telecom and utilities.

Global investors' current exposures to A-Shares are still low, as Northbound volume contributed only 1.6% of A-Shares turnover in July 2017. However, comparing the top 155 northbound holdings (at a whopping 90% total weight) against the 1,651-stock Northbound universe, it showed that the % of stocks with ROE >10%, moderate PE ratio between 10-40x, and yield >1% was significantly higher. Foreign investors pick companies with high profitability and yield, reasonable valuation for margin of safety and mostly large-cap stocks. Furthermore, the consumption theme as well as the A-Shares unique sectors/stocks are significantly overweight - the F&B and home appliance sectors were 14.2% and 7.6% overweight respectively. Cyclical sectors such as non-ferrous metal, construction and machinery sectors, as well as electronics and media sectors were underweight.

The A- and H-Shares markets both experienced profound changes from the exchange of investors through the Stock Connect. While marginal liquidity is the catalyst, the integration of the A- and H-Shares markets will be an important trend over the medium to long term. For the H-shares market, it will end the era when the market is purely driven by international liquidity and some stocks trading at very low valuation. With rising foreign investors' penetration, investors in the A-Shares market will no longer chase highly speculative thematic stocks only while totally ignoring the blue-chip universe.

Currently, the A-shares market is largely decoupled from the global market and more subject to domestic factors. China's gradual integration with the global financial system and the loosening of restrictions on capital flows will lead to a more open, better liquidity environment, while at the same time reducing some of its diversification benefit.

Correlation between the A-Shares and global markets is still low

	STOXX 50	Nikkei 225	S&P 500	Dow Jones	CSI 300	Shanghai Comp	Shenzhen Comp	MSCI China	HSCEI	HSI
STOXX 50	1	0.24	0.65	0.65	0.15	0.14	0.12	0.36	0.36	0.36
Nikkei 225		1	0.14	0.14	0.25	0.25	0.21	0.47	0.48	0.50
S&P 500			1	0.96	0.13	0.13	0.10	0.21	0.21	0.21
Dow Jones				1	0.12	0.12	0.10	0.32	0.21	0.20
CSI 300					1	0.98	0.85	0.56	0.56	0.49
Shanghai Comp						1	0.87	0.55	0.56	0.49
Shenzhen Comp							1	0.46	0.44	0.40
MSCI China								1	0.97	0.96
HSCEI									1	0.96
HSI										1

Source: Bloomberg, CICC (based on daily returns since 2009)