Uncommon truths

Can we ignore China?

Chinese A-shares are due to be included in MSCI indices. Will this be a watershed moment or a damp squib? We suspect neither but continue to prefer Chinese A-shares to US stocks.

Foreign interest in Chinese A-shares comes and goes and has mainly been gone since the roller-coaster ride of 2015. However, with the upcoming inclusion of A-shares in the MSCI Emerging Markets Index and the MSCI ACWI index (in two steps in June and September), some investors will be obliged to take an interest and others may be encouraged to do so.

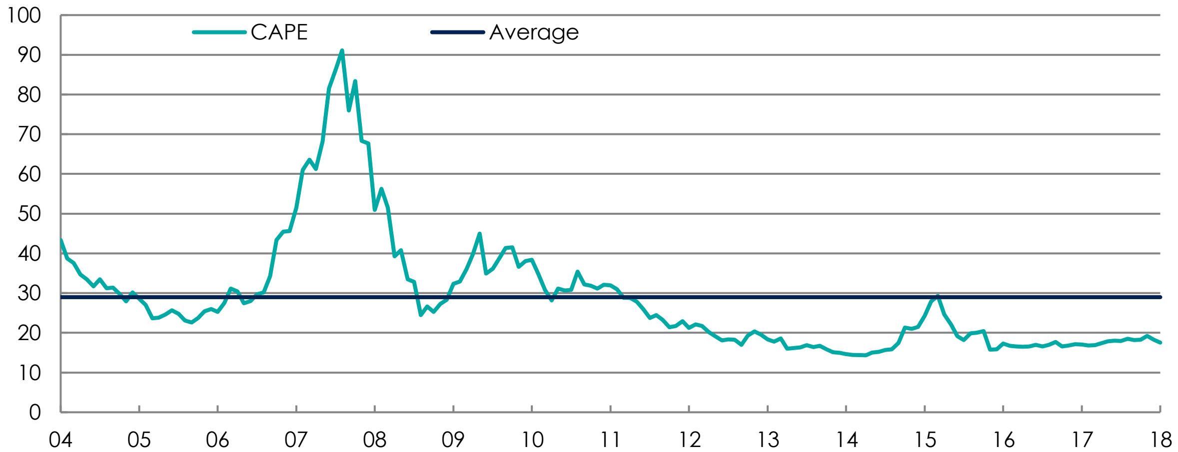
Admittedly, this will be a gradual process, with only 222 large-cap stocks included in the initial phase (versus the 459 large and mid-cap stocks included in the MSCI China A International index) and then with only a 5% index inclusion factor (and that after eliminating shares that cannot be owned by foreigners). Hence, MSCI estimated in June 2017 that A-shares would account for only 0.7% of the MSCI EM index and 0.1% of the MSCI ACWI index.

This is unlikely to cause a flood of money, as 0.7% of the market capitalisation of the MSCI EM index was $38.6bn versus a total of $1,109bn for the MSCI China A International index (both as of March 30, 2018). Nevertheless, it is an important psychological step that could bring A-shares onto the radar of many international investors. Further, MSCI suggests that both the number of stocks and the index inclusion factor could be increased in the future.

Many investors who do not have to invest in China may still be dissuaded by the events of 2015/16. For many, that episode reinforced the suspicion that the Chinese economy is inherently unstable, largely due to overinvestment fuelled by unsustainable levels of debt. At that time, we published an in-depth analysis of China (demographics, resources, growth potential, debt, banking system, markets and data quality). We concluded that, though China may have problems, they are no worse than those of many large developed economies and that China has more ammunition than most to combat such risks (see Pictures of China, first published in September 2015).

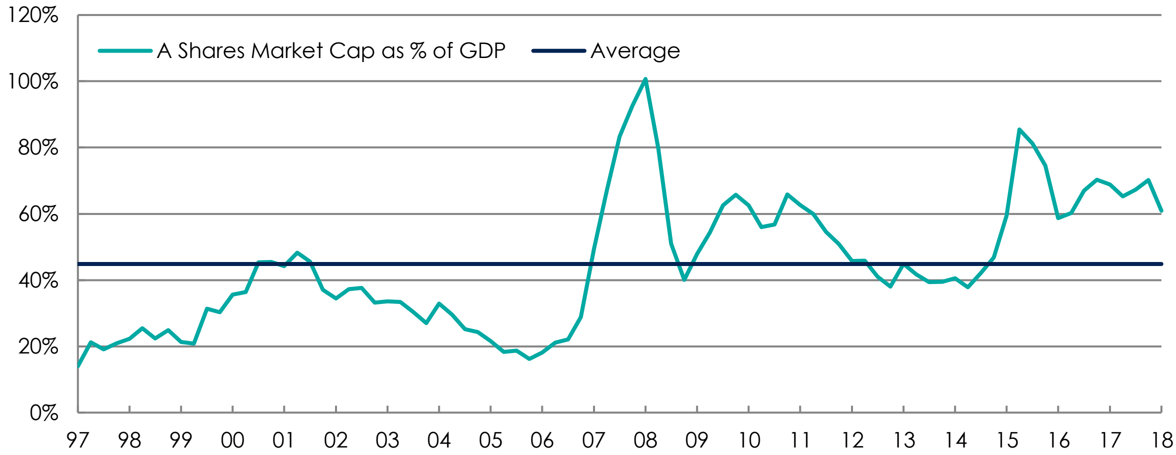
We are in the process of updating that analysis to see how things have changed since then and this document represents a first look from an equity market perspective. Based on the cyclically-adjusted price/earnings ratio (CAPE) history shown in **Figure 1**, we would not categorise Chinese A-shares as expensive. The CAPE was 17.6 on March 30, which is in line with that of Europe but well below those of the US (29.9) and Japan (24.9) and its own historical average of 29.0 (since March 2004).

Figure 1 – China A-share cyclically adjusted price/earnings ratio (CAPE) based on Datastream indices



Notes: based on monthly data (March 2004-March 2018, with average calculated over that period). Cyclically-adjusted price earnings ratio is calculated using a 10-year moving average of earnings. As of March 30, 2018. Source: Datastream and Invesco PowerShares Research

Figure 2 – China A-share market capitalisation as percent of GDP



Notes: Based on quarterly data from 1997 Q1 to 2018 Q1 (the average is measured over that period). This shows the combined market capitalisation of A-shares quoted on the Shanghai and Shenzhen stock exchanges divided by China's GDP (GDP is on a rolling four quarter basis and 2018 Q1 GDP is our estimate).
Source: OECD, Datastream and Invesco PowerShares Research

Figure 2 shows an alternative way of looking at the stock market by comparing the market capitalisation of the A-shares quoted on the Shanghai and Shenzhen stock exchanges with China's gross domestic product (GDP). Although the CAPE shown in **Figure 1** suggests the A-share market moved to a lower valuation norm after the global financial crisis, the market cap to GDP ratio shown in **Figure 2** suggests the opposite. Corporate earnings would appear to have become a larger share of national income, which is perhaps not surprising for an emerging communist economy.

However, even if we take **Figure 2** literally, it is hard to use it as evidence that China's A-share market is abnormally valued. A market cap to GDP ratio of 61% is not excessive, neither in terms of China's own history, nor when compared to other countries (140% for the US, 122% for the UK and 117% for Japan, using the market capitalisation of Datastream indices). For the record, if we include 'B' and 'H' shares, the equivalent Chinese ratio using Datastream indices becomes 43% (they use partial sampling).

So, at worst, we conclude that Chinese A-shares are not expensive and by some measures look cheap. Unfortunately, the same cannot be said for China's currency. **Figure 3** shows that in real (CPI-adjusted) terms, the trade weighted value of the Chinese yuan is close to historical peaks. It may be argued that a persistent current account surplus justifies the gradual appreciation over the last 12 years or so. However, the same could be said about Japan and that has not stopped the yen plumbing historical depths over recent years (in real effective terms). So, we are wary of the currency risk when investing in China.

Figure 3 – Real effective Chinese yuan (1990-2018)

Notes: This is a trade weighted index of the Chinese yuan against a basket of currencies adjusted for CPI inflation differentials (the index is calculated by the OECD). Data is monthly from January 1990 to March 2018.
Source: OECD, Datastream and Invesco PowerShares Research

Nevertheless, the Chinese currency does have some merits. When recently exploring why the US dollar has been so weak (see here), we concluded that the net international debtor status of the US disqualified its currency from being a so-called "safe-haven" (the net international investment position (NIIP) to GDP ratio is around -50%). China, on the other hand, has a positive NIIP of around 20% of GDP, which may be a good thing when global risk aversion rises. We may fear a downward trend in the Chinese yuan, but wouldn't be surprised to see it among the stronger currencies during times of global market stress.

We seem to be in one of those periods right now. Despite the most recent pre-occupation being the threat of a trade war between China and the US, the Chinese currency has strengthened by around 3.5% versus the dollar so far this year (as of April 10).

This is despite such a trade war representing a risk to the Chinese economy. To put matters into perspective, World Bank data suggests Chinese exports were around 20% of GDP in 2016, down from a peak of 37% in 2006 (the equivalent figure for the US is 12%). IMF data suggests that around 19% of Chinese exports went to the US in 2017, whereas only 8% of US exports went to China. Hence, Chinese exports to the US were around 3.7% of Chinese GDP in 2017 (assuming the export to GDP ratio was the same as in 2016). In the case of the US, exports to China were only around 1.0% of GDP.

Though the situation has improved since 2006, when exports to the US represented around 8% of Chinese GDP, an all-out trade war impacting all exports could potentially reduce Chinese GDP by 1%-2% in our opinion (depending on the US price-elasticity of demand for Chinese goods).

Luckily, we are far from that, with US proposals so far targeting less than one-third of the $506bn imported from China in 2017 (Chinese imports from the US amounted to $130bn). President Xi's April 10 speech seems to indicate a willingness to negotiate and hopefully signals the end of this worrying episode.

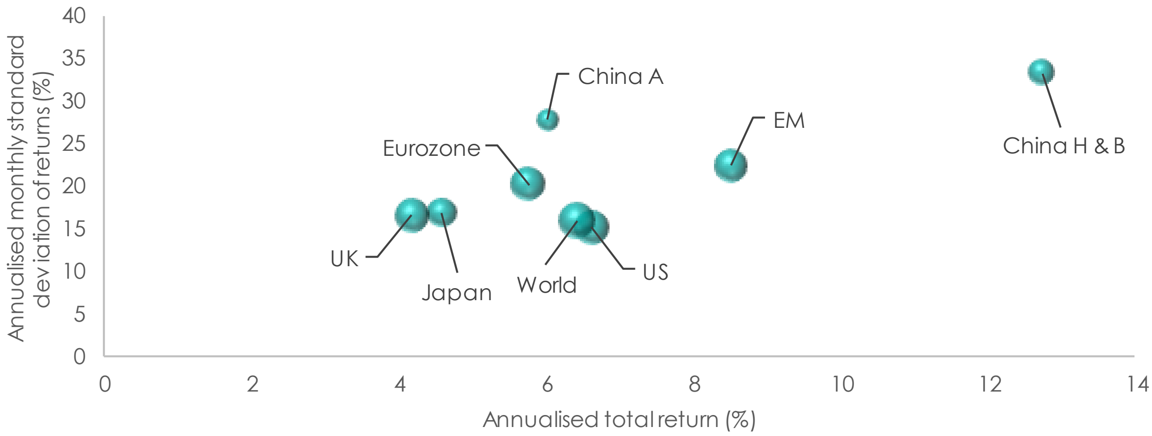
In the meantime, Chinese corporate earnings per share (based on A-shares) have accelerated from the year-on-year declines seen during much of 2015 and 2016 and are now growing at a 10% pace (compared to an average growth rate of 9% since 1995). Though this lags the current rate of growth in Japan and the Eurozone, it is line with that in the US.

Finally, what about risk versus reward? **Figure 4** shows that Chinese A-shares have produced slightly lower total returns than US and world indices over the last 20 years, with higher volatility (H and B-shares seem to have done a better job). This is not so encouraging but the lower correlation to other markets suggests A-shares can help with diversification (a similar picture emerges over the last five years, except that H and B-shares are no longer superior to A-shares).

So, having done a quick tour of Chinese A-shares, history suggests to us that diversification has been the main benefit of investment. However, we find no valuation abnormality and profits are growing again. On this basis we prefer Chinese A-shares to US stocks (which we find to be very expensive). Risks include the elevated valuation of the currency, the threat of a trade war and the fact that volatility tends to be high. We are sufficiently encouraged to update our analysis of the stability of the Chinese economy and financial system (of which, more later).

Unless stated otherwise, data is as of March 30, 2018

Figure 4 – Risk and return in global equity markets over the last 20 years (in US dollars)



Notes: based on monthly data using Datastream total return indices in US dollars from March 31, 1998 to March 30, 2018. The size of the bubbles is in proportion to the correlation with the World index. Past performance is not a guide to future returns. Source: Datastream and Invesco PowerShares Research

Figure 5 – Asset class total returns

Data as at 13/04/2018	Index	Current Level/RY	Total Return (USD, %) 1w	1m	QTD	YTD	12m	Total Return (Local Currency, %) 1w	1m	QTD	YTD	12m
Equities												
World	MSCI	511	1.7	-2.5	1.0	0.2	17.6	1.6	-2.4	1.0	-0.8	14.0
Emerging Markets	MSCI	1170	0.7	-4.2	0.0	1.5	24.7	1.0	-3.4	0.6	1.4	22.7
US	MSCI	2531	2.0	-3.8	0.7	0.0	16.3	2.0	-3.8	0.7	0.0	16.3
Europe	MSCI	1795	1.7	1.1	2.8	0.9	19.2	1.2	1.3	2.3	-2.0	5.2
Europe ex-UK	MSCI	2110	1.5	0.0	2.0	0.9	20.1	1.1	0.9	2.0	-1.1	6.2
UK	MSCI	1249	2.4	4.0	4.8	0.7	16.8	1.2	2.1	3.1	-4.4	2.6
Japan	MSCI	3425	0.4	-1.3	-0.3	0.7	20.8	0.8	-0.5	0.8	-3.9	18.9
Government Bonds												
World	BofA-ML	1.23	0.1	0.3	-0.3	2.3	5.9	-0.1	0.5	-0.2	-0.1	0.5
Emerging Markets	JPM	6.37	-0.1	-0.6	-0.8	3.8	10.5	0.0	0.9	0.0	2.8	8.7
US (10y)	Datastream	2.84	-0.4	0.3	-0.7	-3.1	-2.9	-0.4	0.3	-0.7	-3.1	-2.9
Europe	Bofa-ML	0.73	0.5	0.8	0.1	3.9	17.3	0.0	1.4	-0.1	1.3	1.1
Europe ex-UK (EMU, 10y)	Datastream	0.51	0.4	0.5	0.1	2.5	14.3	-0.1	1.0	-0.1	-0.2	-1.5
UK (10y)	Datastream	1.48	0.8	2.3	0.8	3.4	11.8	-0.4	0.4	-0.7	-1.8	-1.8
Japan (10y)	Datastream	0.04	-0.3	-0.7	-1.0	5.0	1.9	0.0	0.1	0.1	0.2	0.3
IG Corporate Bonds												
Global	BofA-ML	3.01	0.2	0.2	0.2	-0.6	5.9	0.0	0.2	0.0	-1.5	1.4
US	BofA-ML	3.85	-0.1	0.3	0.0	-2.2	1.5	-0.1	0.3	0.0	-2.2	1.5
Europe	BofA-ML	0.99	0.6	-0.6	0.4	2.5	17.5	0.1	0.0	0.2	-0.2	1.3
UK	BofA-ML	2.78	1.1	1.9	1.2	3.5	14.4	0.0	0.0	-0.4	-1.8	0.5
Japan	BofA-ML	0.29	-0.4	-0.7	-1.1	5.0	2.2	0.0	0.1	0.0	0.3	0.6
HY Corporate Bonds												
Global	BofA-ML	5.84	0.7	0.4	0.9	0.7	7.4	0.5	0.4	0.9	0.1	4.5
US	BofA-ML	6.36	0.8	0.7	1.2	0.2	4.6	0.8	0.7	1.2	0.2	4.6
Europe	BofA-ML	3.32	1.1	-0.4	1.0	2.9	21.8	0.6	0.2	0.8	0.3	4.9
Cash (Overnight LIBOR)												
US		1.70	0.0	0.1	0.1	0.4	1.2	0.0	0.1	0.1	0.4	1.2
Euro Area		-0.44	0.4	-0.5	0.1	2.6	15.7	0.0	0.0	0.0	-0.1	-0.4
UK		0.48	1.1	2.0	1.6	5.5	14.3	0.0	0.0	0.0	0.1	0.3
Japan		-0.03	-0.4	-0.7	-1.0	5.0	1.6	0.0	0.0	0.0	0.0	0.0
Real Estate (REITs)												
Global	FTSE	1816	0.5	0.5	0.6	-2.8	5.4	0.0	1.0	0.3	-5.3	-9.1
Emerging Markets	FTSE	2538	2.9	1.1	2.0	6.2	35.8	2.3	1.6	1.8	3.5	17.1
US	FTSE	2645	-0.7	-0.6	-0.9	-8.6	-7.2	-0.7	-0.6	-0.9	-8.6	-7.2
Europe ex-UK	FTSE	3642	1.0	2.4	1.4	0.4	26.1	0.5	2.9	1.1	-2.2	8.7
UK	FTSE	1570	0.7	4.2	2.5	2.2	16.7	-0.5	2.3	0.9	-3.0	2.5
Japan	FTSE	2613	0.8	2.4	0.4	7.8	6.8	1.2	3.3	1.5	2.9	5.1
Commodities												
All	GSCI	2699	5.5	6.3	3.3	5.6	14.5	-	-	-	-	-
Energy	GSCI	505	7.6	10.8	3.8	9.1	22.8	-	-	-	-	-
Industrial Metals	GSCI	1411	4.1	1.5	4.9	-2.7	18.9	-	-	-	-	-
Precious Metals	GSCI	1609	1.0	1.2	1.7	2.0	2.1	-	-	-	-	-
Agricultural Goods	GSCI	398	0.2	-1.4	1.5	4.8	-6.0	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.23	0.4	-0.5	0.1	2.8	16.2	-	-	-	-	-
JPY		107.35	-0.4	-0.7	-1.0	5.0	1.6	-	-	-	-	-
GBP		1.42	1.2	1.9	1.6	5.3	13.8	-	-	-	-	-
CHF		1.04	-0.3	-1.9	-0.9	1.2	4.5	-	-	-	-	-
CNY		6.28	0.5	0.7	0.0	3.7	9.8	-	-	-	-	-

*Notes: *The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation). Past performance is no guarantee of future results. Please see appendix for definitions, methodology and disclaimers.*
Source: Datastream and Invesco PowerShares Research.

Figure 6 – Equity sector total returns relative to local market (%)

Data as at 13/04/2018	US					Europe				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Oil & Gas	**3.9**	**10.1**	**5.2**	**-0.2**	**-8.3**	**0.9**	**5.1**	**3.9**	**4.8**	**3.1**
Materials	**0.7**	**-0.5**	**1.4**	**-3.4**	**-0.9**	**0.8**	**-1.7**	**-0.1**	**-0.8**	**4.9**
Basic Resources	1.6	2.9	2.4	0.6	6.8	2.2	-0.2	0.5	0.9	11.6
Chemicals	0.9	-0.8	1.8	-3.5	-1.2	-0.5	-2.9	-0.7	-2.4	-0.7
Industrials	**-0.4**	**0.1**	**-1.1**	**-1.9**	**-0.9**	**-0.1**	**-1.9**	**-1.2**	**-0.6**	**1.1**
Construction & Materials	-1.6	-2.7	-2.2	-7.2	-13.6	-0.6	-2.2	-1.6	-2.6	-4.7
Industrial Goods & Services	-0.1	0.6	-0.8	-1.3	0.2	0.0	-1.9	-1.1	-0.1	2.7
Consumer Discretionary	**-1.5**	**-0.3**	**-0.8**	**3.1**	**2.0**	**0.7**	**2.9**	**1.4**	**3.6**	**4.2**
Automobiles & Parts	-0.1	4.9	2.8	-5.2	-1.4	0.7	2.9	0.3	6.6	16.9
Media	-2.7	-1.5	-1.2	-6.9	-19.9	-0.8	0.2	0.1	-0.3	-6.9
Retail	-1.1	-1.3	-1.5	6.2	8.8	0.8	1.4	1.7	0.0	-4.4
Travel & Leisure	-2.0	0.4	-1.2	-3.0	0.1	-0.5	-3.8	-0.9	-3.6	-0.9
Consumer Staples	**-1.7**	**0.9**	**-0.7**	**-7.0**	**-15.1**	**-1.2**	**2.4**	**0.1**	**-1.6**	**-5.6**
Food & Beverages	-1.5	0.7	-0.3	-5.4	-13.3	-1.9	-1.8	-1.7	-4.4	-3.4
Personal & Household Goods	-2.2	2.0	-0.1	-5.7	-14.7	-0.8	5.3	1.3	0.2	-6.6
Healthcare	**0.4**	**-1.0**	**0.1**	**-0.4**	**-3.2**	**-0.6**	**0.3**	**-1.0**	**-1.4**	**-8.8**
Financials	**-1.0**	**-2.2**	**-1.0**	**-1.2**	**4.8**	**0.3**	**-1.3**	**-0.2**	**0.4**	**4.7**
Banks	-1.2	-3.4	-0.7	-1.1	7.0	0.2	-3.4	-0.7	-1.6	3.3
Financial Services	-0.8	-2.2	-1.6	-3.7	4.3	-0.3	0.2	-0.3	3.8	8.0
Insurance	-0.8	0.7	-1.0	-2.5	-4.1	1.2	1.5	1.0	3.7	8.1
Real Estate	-3.1	2.3	-2.4	-6.6	-15.3	-0.9	2.6	-1.2	-0.4	0.6
Technology	**1.7**	**-1.3**	**0.7**	**5.1**	**13.4**	**1.2**	**-4.2**	**0.3**	**2.4**	**5.8**
Telecommunications	**-1.3**	**0.9**	**-0.1**	**-6.9**	**-17.5**	**0.3**	**0.8**	**1.9**	**-2.9**	**-8.1**
Utilities	**-3.3**	**4.9**	**-2.1**	**-4.6**	**-14.3**	**-0.1**	**2.9**	**-0.1**	**1.9**	**0.7**

Notes: We use a sector classification created by merging the two main systems used by Standard & Poor's (S&P) for the US and STOXX for Europe. We have decided to classify our 10 top level industries using categories that most closely resemble the Global Industry Classification Standard (GICS) and at the level below that (super sectors) we are using the Industry Classification Benchmark (ICB). The former is used for the S&P 500 index and the latter for the STOXX 600, our benchmark indices. The two systems overlap in most cases and the only material difference seems to be in the consumer sectors. Therefore, we define consumer staples as the aggregate of personal & household goods and food & beverage, while consumer discretionary includes automobiles & parts, media, retail and travel & leisure. For the rest, we assume 100% overlap for the corresponding top-level sectors. Past performance is no guarantee of future results. The Global Industry Classification Standard was developed by and is the exclusive property and service mark of MSCI Inc. and Standard & Poor's.
Source: Datastream and Invesco PowerShares Research

Figure 7 – Model asset allocation

	Neutral	Policy Range	Allocation	Position vs Neutral	Hedged	Currency
Cash	**5%**	**0-10%**	**10%**			
Cash	2.5%		10%			
Gold	2.5%		0%			
Bonds	**45%**	**10-80%**	**41%**			
Government	30%	10-50%	18%			
US	10%		11%			
Europe ex-UK (Eurozone)	8%		2%			
UK	2%		2%		100%	JPY
Japan	8%		0%			
Emerging Markets	2%		3%			
Corporate IG	10%	0-20%	18%			
US Dollar	5%		10%		50%	JPY
Euro	3%		4%			
Sterling	1%		2%		100%	JPY
Japanese Yen	1%		2%			
Corporate HY	5%	0-10%	5%			
US Dollar	4%		5%			
Euro	1%		0%			
Equities	**45%**	**20-70%**	**43%**			
US	25%		8%			
Europe ex-UK	7%		14%			
UK	4%		4%			
Japan	4%		8%			
Emerging Markets	5%		9%			
Real Estate	**3%**	**0-6%**	**6%**			
US	1%		2%		50%	JPY
Europe ex-UK	1%		2%			
UK	0.5%		0%			
Japan	0.5%		1%			
Emerging Markets	0%		1%			
Commodities	**2%**	**0-4%**	**0%**			
Energy	1%		0%			
Industrial Metals	0.3%		0%			
Precious Metals	0.3%		0%			
Agriculture	0.3%		0%			
Total	**100%**		**100%**			
Currency Exposure						
USD	49%		33%			
EUR	21%		24%			
GBP	8%		4%			
JPY	14%		23%			
EM	7%		14%			
Total	**100%**		**100%**			

Notes: This is a theoretical portfolio and is for illustrative purposes only. See the latest The Big Picture document (published on March 21, 2018) for more details. It does not represent an actual portfolio and is not a recommendation of any investment or trading strategy.
Source: Invesco PowerShares Research

Figure 8– Model sector allocations

	US		Europe		Preferred
	Neutral	Model	Neutral	Model	Region
Oil & Gas	**5.8%**	**Overweight**	**5.8%**	**Overweight**	**Europe**
Materials	**2.3%**	**Underweight**	**6.8%**	**Underweight**	**Europe**
Basic Resources	0.4%	Neutral	3.3%	Neutral	Europe
Chemicals	1.9%	Underweight	3.5%	Underweight	Europe
Industrials	**12.1%**	**Neutral**	**14.3%**	**Neutral**	**US**
Construction & Materials	0.6%	Underweight	2.7%	Neutral	Europe
Industrial Goods & Services	11.5%	Neutral	11.6%	Neutral	US
Consumer Discretionary	**14.9%**	**Neutral**	**11.0%**	**Overweight**	**Europe**
Automobiles & Parts	0.8%	Neutral	3.6%	Neutral	Europe
Media	2.8%	Neutral	2.2%	Underweight	US
Retail	8.4%	Neutral	3.4%	Overweight	Europe
Travel & Leisure	3.0%	Overweight	1.9%	Overweight	US
Consumer Staples	**8.5%**	**Neutral**	**16.6%**	**Neutral**	**US**
Food & Beverage	3.8%	Overweight	7.2%	Overweight	US
Personal & Household Goods	4.7%	Neutral	9.4%	Underweight	US
Healthcare	**12.6%**	**Overweight**	**11.1%**	**Neutral**	**US**
Financials	**19.0%**	**Underweight**	**21.9%**	**Neutral**	**Europe**
Banks	6.6%	Neutral	12.6%	Neutral	Europe
Financial Services	5.8%	Underweight	2.1%	Overweight	Europe
Insurance	3.7%	Underweight	5.4%	Overweight	Europe
Real Estate	2.9%	Overweight	1.8%	Neutral	US
Technology	**19.8%**	**Underweight**	**4.1%**	**Underweight**	**US**
Telecommunications	**2.0%**	**Overweight**	**4.0%**	**Underweight**	**US**
Utilities	**2.9%**	**Underweight**	**4.4%**	**Underweight**	**US**

Notes: These are theoretical allocations which are for illustrative purposes only. They do not represent an actual portfolio and are not a recommendation of any investment or trading strategy. See the latest Strategic Sector Selector (January 23, 2018) for more details.
Source: Datastream and Invesco PowerShares Research.

Appendix

Definitions of data and benchmarks (for Figure 5)

Sources: we source data from Datastream unless otherwise indicated.

Cash: returns are based on a proprietary index calculated using the Intercontinental Exchange Benchmark Administration overnight LIBOR (London Interbank Offer Rate). The global rate is the average of the euro, British pound, US dollar and Japanese yen rates. The series started on 1st January 2001 with a value of 100.

Gold: London bullion market spot price in USD/troy ounce.

Government bonds: Current levels, yields and total returns use Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK, and the Bank of America Merrill Lynch government bond total return index for the World and Europe. The emerging markets yields and returns are based on the JP Morgan emerging markets global composite government bond index.

Corporate investment grade (IG) bonds: Bank of America Merrill Lynch investment grade corporate bond total return indices.

Corporate high yield (HY) bonds: Bank of America Merrill Lynch high yield total return indices

Equities: We use MSCI benchmark gross total return indices for all regions.

Commodities: Goldman Sachs Commodity total return indices

Real estate: FTSE EPRA/NAREIT total return indices

Currencies: Global Trade Information Services spot rates

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