IS IT TIME TO GET EXCITED ABOUT CHINESE EQUITIES?

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Is progress actually being made toward the ever-elusive "trade deal" between China and the U.S.?

Thus far in 2019:

- China's equity market has been one of the best performers globally after a tough 2018. Part of this may be a recovery rally; part of it may be the recognition of various stimulative measures within China—plus the possibility of a trade deal.
- Beyond China, global equity markets have generally been rallying, as have global bond markets (whose yields have fallen) and the price of gold. A perception of high political risk and a global economic slowdown have been juxtaposed with a strong asset price rally.

Emerging Markets Charging Forward as the U.S. Federal Reserve Pauses for Now

One of the more remarkable transitions we've seen globally is how, in 2018, the Federal Reserve (Fed) was expected to hike policy rates four times, followed by three more increases in 2019. Merely 12 months later, we find ourselves wondering if they will hike policy rates *at all* this year.

When shifts like this occur, opportunities can present themselves within emerging market equities, because the U.S. dollar can move from being a headwind to a tailwind for unhedged returns.[1]

- In 2018, the dollar's appreciation took away 4.50% from unhedged emerging market equity investors.
- Thus far in 2019, the dollar's depreciation added nearly 0.75% to unhedged emerging market equity investors.

This can be additive if markets also have a catalyst to change their view on a major market like China and shifts from a b earish to a bullish sentiment can occur.

China Is a Market That Moves in Sweeping Trends

One of the primary questions many investors face is whether to take exposure to a broad benchmark or whether a more country-specific basis makes more sense.

Figure 1 indicates the performance of the S&P China 500 Index, one of the broadest equity benchmarks for China, against the MSCI Emerging Markets Index.

- It's easy to remember the start of 2016, when China was destined for the so-called "hard landing." This was the catalyst for a trend of China equity underperformance until the end of the first quarter of 2017.
- From about the end of April 2017 to May 2018, there was a strong year of outperformance of China's equities over broader emerging markets. During this period, we started hearing about the "China-FAANG" stocks as the Information Technology sector was strong, similar to what was seen in the U.S.
- Emblematic of the trade tensions in place through the second half of 2018, China's equities began to underperform broader emerging markets. This was a tough period for emerging markets overall, featuring tightening monetary policy from the Fed and a strengthening U.S. dollar. Notably, China is also the world's second largest economy, so it is difficult to see much in the way of performance from emerging markets without China following suit.
- Similar to how the appreciation of the British pound may be implying the possibility of an eleventh-hour BREXIT deal coming together, China's equity market seems to be front-running the possibility of a trade deal with the U.S. We've seen outperformance of China's equities to start the year.

Figure 1: The Sweeping Trends of China's Equities vs. Broader Emerging Markets

Index Name	YTD 2019	2018	2017	2016	Avg. Ann. Return since August, 28 2015
S&P 500 China Index	16.3%	-23.3%	43.9%	-8.3%	6.8%
MSCI Emerging Markets Index	9.8%	-14.6%	37.3%	11.2%	10.0%
Difference	6.5%	-8.7%	6.6%	-19.5%	-3.2%

Source: Bloomberg, with data from August 28, 2015, to February 22, 2019. Past performance is not indicative of future results. You cannot invest directly in an index.

It may be tempting to think about individual sectors within China to increase the octane and cyclical nature of any strategy. Figure 2 indicates just how challenging that might be. In 2017, for example, the spread between the best and the worst of the GICS sectors was around 100%. To mitigate the risk, we think broad exposure to China's equity market, as opposed to betting on certain sectors, will benefit any asset allocation looking to invest in China.

Figure 2: Gauging the Massive Shifts in China's Sector Performance

YTD 2019		2018		2017		2016		Avg. Ann. Return since 28 August 2015	
Top 3 Sectors		Top 3 Sectors		Top 3 Sectors		Top 3 Sectors		Top 3 Sectors	
Info. Tech.	33.5%	Utilities	7.7%	Real Estate	97.1%	Materials	17.5%	Info. Tech.	25.2%
Cons. Disc.	26.1%	Energy	-2.9%	Info. Tech.	91.7%	Energy	16.3%	Materials	12.3%
Health Care	18.6%	Comm. Svcs.	-5.2%	Cons. Disc.	61.6%	Info. Tech.	9.6%	Health Care	10.4%
Bottom 3 Sectors		Bottom 3 Sectors		Bottom 3 Sectors		Bottom 3 Sectors		Bottom 3 Sectors	
Energy	15.3%	Health Care	-27.3%	Industrials	16.3%	Cons. Disc.	-9.7%	Utilities	1.9%
Materials	17.1%	Info. Tech.	-27.6%	Energy	12.6%	Industrials	-11.6%	Comm. Svcs.	-2.4%
Utilities	8.5%	Cons. Disc.	-39.6%	Comm. Svcs.	-1.8%	Utilities	-15.0%	Industrials	-3.0%

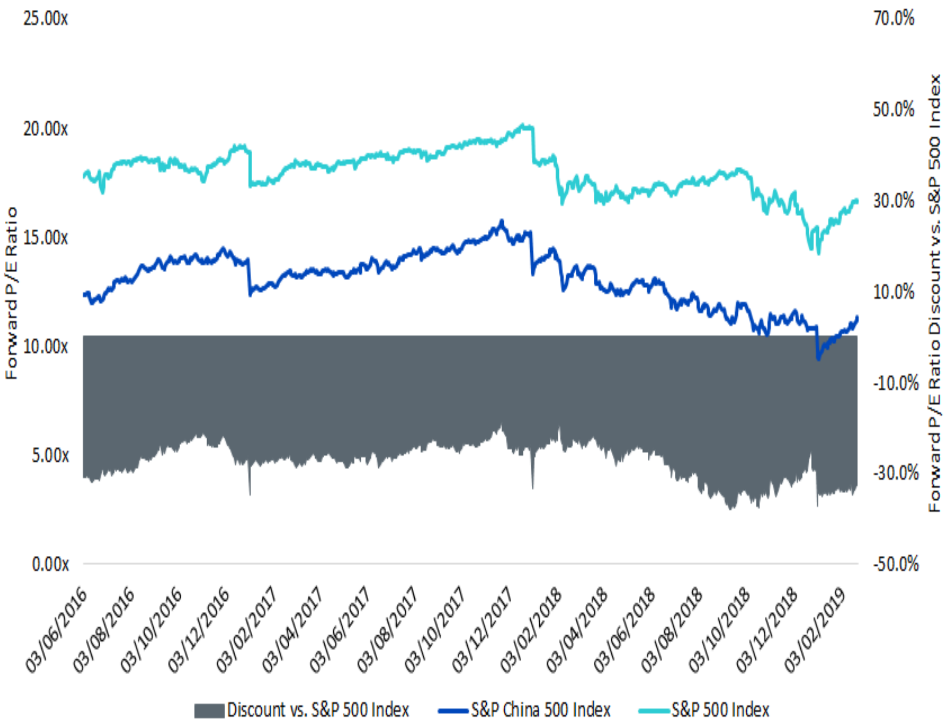
Source: Bloomberg, with data from August 28, 2015, to February 22, 2019. Sectors are from the MSCI China Index universe, and returns are measured in U.S. dollars without the reinvestment of dividends. Past performance is not indicative of future results. You cannot invest directly in an index.

Does China's Valuation Indicate Strong Return Potential?

China, like any emerging market country, is never without significant risks. For example, it is easy to tweet about possible trade deals in order to grab headlines, but to actually negotiate bilateral trade agreements all the way to completion is notoriously difficult.

Fortunately, China's equity market is currently trading near the steepest discount on a forward P/E ratio basis that we have seen since June 2016. A lower forward P/E ratio on its own could mean very little, but seeing a lower valuation at a time when one is getting ready to possibly capitalize on an improvement in relations between China and the U.S. could make such a strategy more interesting.

Figure 3: China's Equities Trade at a Steep Discount to U.S. Equities



Source: Bloomberg, with data from June 3, 2016, to February 22, 2019, based on availability of forward P/E ratio data within Bloomberg for the S&P China 500 Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion: China May Go Down, but It's Never Out

It is easy to get wrapped up in the short-term thought processes and headlines that always surround China. The fact is, this is the world's second largest economy. It is a massive market that, even if growth is slowing, is still far outpacing what's seen in developed markets. There can always be downdrafts, but in our view it's important to look forward, as the next rally can also be right around the corner.

[1]Source: Bloomberg, with data for 2018 from 12/31/17 to 12/31/18 and for 2019 YTD from 12/31/18 to 2/22/19.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Real policy rate : Reflects the policy rate controlled by the central bank, net of the expected inflation rate.

Headwind : challenges to performance or expectations of performance.

Tailwind : Situation that will help growth in a sector/asset class because of some development in another sector/asset class.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Bullish : a position that benefits when asset prices rise.

S&P China 500 Index : Comprises 500 of the largest, most liquid Chinese companies while approximating the sector composition of the broader Chinese equity market. All Chinese share classes including A-shares and offshore listings are eligible for inclusion.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

GICS : Global Investment Classification System, which assigns companies to specific industries and sectors.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.