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July 2020

China multi-asset investing strategy Q&A

China's equity and bond markets have had a busy year. We ask Gian Plebani, Investment Solutions Portfolio Manager, about his current strategy and where he sees opportunities in China's markets.

- We have seen strong policy support from the Chinese government and we believe positive market sentiment will benefit China A-share markets;
- Recent data show that China's economy is rebounding and we believe it will remain resilient in the coming months;
- We see two key short-term risks: the impact of COVID-19 and potential volatility ahead of the November US election.
- We believe, however, that China is better positioned if a second wave COVID-19 wave happens, and doubt that the phase 1 US-China trade deal is in jeopardy;

How have you adjusted your China allocation approach given the events of recent months?

Generally speaking, we haven't made any major directional changes because of recent market uncertainty.

However, we have made some relative changes, mainly by putting more emphasis on onshore China assets. This breaks down in two ways.

Firstly, on the risk side we have kept a preference for China A shares, despite slightly reducing our overall equity allocation since the end of 1Q20.

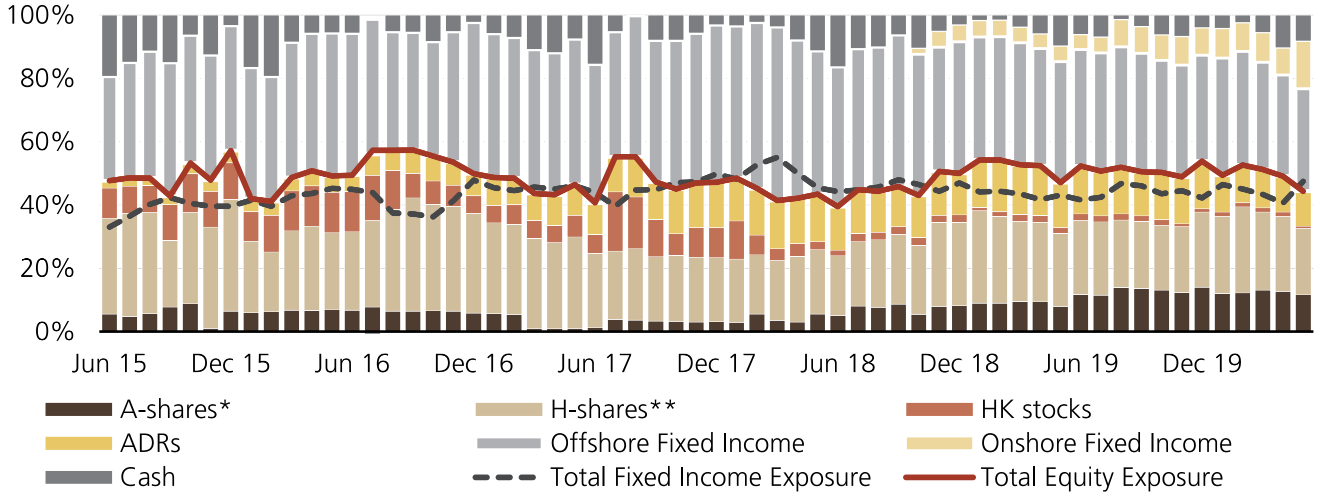
That's because we have seen strong policy support from the Chinese government. This support has bolstered both onshore investor sentiment and A-share market performance.

The sentiment factor is important here. Sentiment feeds the A-share market because it is driven by retail investors, and that's different to offshore markets for China stocks, which are more driven by longer-term more fundamentally-driven institutional investors. For this main reason we see differentiation between the offshore and onshore markets.

We have kept a preference for China A shares….. Strong policy support has bolstered both onshore investor sentiment and A-share market performance.

As the Chinese government has made clear its ongoing support for the economy, we believe positive market sentiment will continue in the coming months, and will particularly benefit the A-share space, so we have maintained our allocations accordingly.

Strategy allocation, Jun 2015-Jun 2020



Source: UBS Asset Management, July 2020

Secondly, we have put more emphasis on onshore China fixed income - to China government and policy bank bonds in particular. That's because we see them as a relative safe haven asset.
Put together, these changes amount to maintaining risk on the one hand and taking safer bets on the other, which we feel is consistent with our 'risk-aware' approach.

How are your cash levels currently and how have they evolved over the past 3 months?

We have reduced our cash levels after market volatility in March and April. Risk assets have rebounded since then.

For us, cash is a risk-off asset and the balance between cash and risky assets is an important part of our process.

However, we also see onshore China fixed income as a risk-off asset, so we have put more emphasis on this asset class over the past couple of months.

What is your top-down view on the outlook for China's economy this year and into 2021?

Recent data show that China's economy is rebounding. For example, Purchasing Manager's Indices (PMIs) for both the manufacturing and services sector have shown expansion recently, with manufacturing PMIs showing growth for four straight months between April and July.

Looking ahead, we believe China's economy will remain resilient. The Chinese government has committed to prioritizing employment and relaxing the deleveraging campaign.

We believe these factors, as well as China's remaining capacity to respond to shocks and its first-in, first-out status on the global pandemic, have allowed its domestic equities to hold up better in 2020 compared to most other equity markets globally.

What are the key risks you see in the next three-to-six months?

Two key risks: the impact of COVID-19 and potential volatility ahead of the US election in November.

There's still uncertainty about the shock to global demand and the precise negative impact on China's economy from the COVID-19 outbreak.

This is a key risk; however we believe that China is better positioned than other countries if a second wave of COVID-19 happens.

That's because firstly, the recent experience in Beijing demonstrates how effective the Chinese authorities can be in suppressing an outbreak and, secondly, that Chinese more strictly observe precautionary measures, like facemasks and social distancing, compared to other outbreak hotspots.

As for the second risk, we see potential instability in the US/China relationship ahead of the November US Presidential election.

We expect a lot of finger-pointing at China from the presidential candidates in the coming months, which may introduce some tension to the relationship and volatility to the markets.

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We doubt, however, that the phase 1 trade deal is in jeopardy for reasons we will explain later.

How can onshore China fixed income support a China multi-asset strategy?

We see onshore China fixed income, and particularly government and policy bank bonds, as a safe haven asset which brings important diversification benefits to since the asset class is negatively correlated to Chinese equity and Chinese credit and has low correlation to overseas bond markets.

Do you see opportunity in China A-shares from an asset allocation perspective?

We mentioned before that from a structural perspective the structural make-up of the China A-share market has different characteristics compared to offshore markets for China equities, which allows us a diversification opportunity and adds a different component to the strategy.

Also, the index inclusion process means that A-shares are becoming a more prominent factor in global asset allocation portfolios, so there should be structural support from global flows.

Finally, from a long-term perspective, the opening up of onshore markets and related access channels - like Stock Connect – creates new possibilities for us as it internationalizes and institutionalizes the market.

China A-shares offer a different opportunity set than say H-shares and ADRs, so we look to exploit these opportunities.

What's happening in the China real estate sector?

Market wise, we are seeing demand return to normal after the market disruptions caused by the Covid-19 outbreak. Recent data show a pick-up in price growth, which tells us that demand remains healthy.

We continue to like the sector from a structural perspective. The sector continues to rationalize with smaller players either leaving the space, or being taken over by larger players.

We favor larger, higher quality names in the sector, particularly those who have grown market share and a diverse range of funding options.

Are there any risks to the first-round US-China trade deal?

We mentioned before that there is a risk of higher volatility within the US/China relationship prior to the election. We believe a rollback on the phase 1 deal is possible, but not likely.

Our base case is that both sides keep the phase 1 deal as it is. Looking particularly at the US side, we feel the existing deal is a positive one for the US agriculture sector, which is a key constituency in US politics.

The Chinese government has committed to substantial purchases of US farm products, like soybeans, and we doubt the US side would want to jeopardize this in the lead up to the election.