INTERPRETING CHINA

Chinese equity markets – opportunities in difference

China A and H shares offer two routes to accessing the growth of Chinese corporates. On the surface, the difference is clear – A shares are issued by mainland incorporated companies and are listed in Shenzhen or Shanghai, while H shares are listed in Hong Kong, are more freely tradable for overseas investors, and follow international accounting and reporting standards. **Shao Ping Guan, Senior Portfolio Manager**, takes us through some of the nuances.

With the deep relationship between these two equity markets – and around 150 companies dual-listing – potential differences in valuation between markets are, of course, a keen point of interest for us as investors. Historically, dual-listed shares in mainland China and in Hong Kong of the same company have not always traded at par, and the Hang Seng A/H premium index is a good proxy to the relative valuations of these dual-listed shares. The index is now trading at 144, indicating that A shares are 44% more expensive than their H share equivalents. While this level is high, it is still far from the historical peak, spiking as high as 200 in 2008.

However, the Hang Seng A/H premium index focuses mainly on large cap companies in sectors such as banks, insurance, and energy. This is not, in our view, a good representation of the overall market valuation gap. Looking at past performance, the A/H premium has also not been a good indicator of relative performance of onshore and offshore markets. With more than 6,400 shares listed in mainland China and Hong Kong, and only around 150 stocks listed in both, the A/H Premium Index represents only a small part of the full opportunity set. And most Chinese companies are unique to their listing location, complementing each other and forming a holistic investable universe from a portfolio construction point of view.

A persistent valuation gap?

Our Allianz All China Equity strategy invests across the broadest China opportunity set and, barring any liquidity-related issues, we will invest in the cheaper share class of a

Shao Ping Guan
Senior Portfolio Manager

dual-listed company. This reflects our view that over the long term, there will libely be gradual convergence between onshore and offshore markets in China. That said, we do not see this being arbitraged away easily in the short-term.

There are limited options to arbitrage these price differentials, as the cost and risk of shorting in the A-shares markets is prohibitive. In addition, the investor base and behaviour in the onshore and offshore markets are different – most offshore investors are global institutions, more sensitive to global sentiment and reactive to news from China that makes international headlines. Domestic China investors are predominantly retail and are thus more sensitive to domestic policy changes and day-to-day developments on the ground. The retail investor base in China tends to react more to short-term incentives and domestic policy than overseas institutions, while it also has fewer investment alternatives outside of the home market.

Performance synchronizing

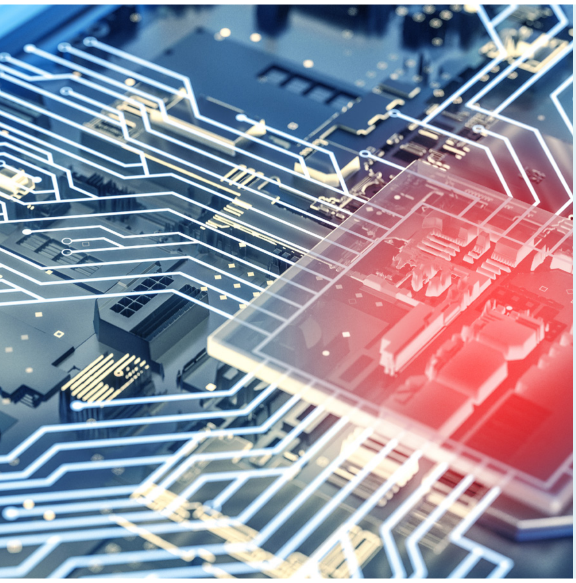
The two markets have performed differently – the historical correlation between China A and China H is only 0.59, meaning 59% of the time these two markets have moved in different directions. The historical, single-year performance gap between different China markets has been as high as 83% in 2015 (chart below). Yet this divergence has been declining over time, suggesting that markets have become more synchronized, but are by no means in lock step.

Indeed, taking a deeper look at the composition of the listed Chinese companies, it is clear that the index composition of MSCI China (mostly Hong Kong listings) is very different to that of MSCI China A Onshore (comprised exclusively of A-share listings). Hong Kong listed stocks are generally focused in in the areas of internet, financials, and state-owned enterprises (SOEs). In contrast, the A-share market provides broader sector exposure and, in our view, gives investors more direct access to exciting developments in "new economy" growth areas of the market – electric vehicles, artificial intelligence, healthcare, and green technology, for instance. Within the consumer area, mainland listings offer diverse representation from a variety of areas including food and liquor, advanced auto components, home appliances, and so on.

Difficult to time the different China markets: portfolio construction close to 'region-neutral'

Calendar year return for different China equity markets

Source: Thomson Reuters Datastream, Allianz Global Investors, as of 31 August 2023. Index used for caclulations. Shanghai SE Corporate Index, Shenzhen SE Composite Index, Hang Seng China Enterprise Index and BNY Mellon China ADR Index. Investment includes risks. **Past performance is not indicative of future performance. Individual performance will vary.**



Implications for investors

We see ongoing efforts by China to improve connectivity between the two markets, with the launch of the Shanghai–Hong Kong Stock Connect in 2014 and Shenzhen-Hong Kong Stock Connect in 2016. Investors should understand the nuances between the two markets, and we believe China H shares offer good complements to the onshore China universe. A combination of both markets gives investors a proper balance between old and new economy stocks – a true representation of China's future potential – while dispersion between the two markets can also present opportunities.