CIO Perspectives

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Key Points

- Fund flow data show a rebound in sentiment for China equities. The market registered sharp inflows of USD34.8b in 2018, almost completely reversing prior years' outflows.
- The strong flow of funds reflects rising optimism in China and EM in general, on the back of the Fed's rate hike trajectory that is expected to peak out.
- Current valuation of HSCEI has, to a large extent, priced in the current economic slowdown. Policy stimulus will be a medium-term tailwind.
- Adopt a barbell strategy. Favour China equities for capital gain potential.

Global cross assets

Returns of cross assets around the world

Index	Close	Overnight	YTD
DJIA	25,425.76	1.5%	9.0%
S&P 500	2,744.73	1.3%	9.5%
NASDAQ	7,414.62	1.5%	11.7%
Stoxx Europe 600	362.78	0.5%	7.4%
DAX	11,126.08	1.0%	5.4%
CAC 40	5,056.35	0.8%	6.9%
FTSE 100	7,133.14	0.1%	6.0%
MSCI AxJ	642.31	0.3%	7.7%
Nikkei 225	20,864.21	2.6%	4.2%
SHCOMP	2,671.89	0.7%	7.1%
Hang Seng	28,171.33	0.1%	9.0%
MSCI EM	1,042.13	0.6%	7.9%
UST 10-yr yield*	2.69	3.4	0.3
JGB 10-yr yield*	-0.02	1.5	-1.4
Bund 10-yr yield*	0.13	1.2	-10.9
US HY spread*	4.05	-10.0	-121.0
EM spread*	375.72	-4.9	-58.9
WTI (USD)	53.10	1.3%	16.9%
LMEX	2,891.70	-0.9%	3.2%
Gold (USD)	1,310.80	0.2%	2.2%

Source: Bloomberg
* Changes in basis points

Surging fund flows underpin China equities

Fund flow data from EPFR Global show a rebound in sentiment on China equities. Between 2014 and 2017, China suffered net outflows of USD39.5b. But all this changed in 2018 as China registered net inflows of USD34.8b – reversing the bulk of prior years' outflows. The bottoming out of sentiment in mid-2017 (Figure 1) coincided with the trough in corporate earnings (Figure 2).

Robust China fund flows is a function of broader EM optimism. The strong flow of funds into China did not happen in isolation. It reflects a gradual rebound in risk appetite for the broader Emerging Markets (EM) space as investors pare their exposure to Developed Markets (DM). To put things in context, we tracked the flow of funds into these regions over the past few years. Between 2014 and 2017, DM equities saw net inflows totalling USD319.6b, while EM registered net outflows totalling USD34.1b. The exit of funds from EM came amid concern over the US Federal Reserve's normalisation of monetary policy.

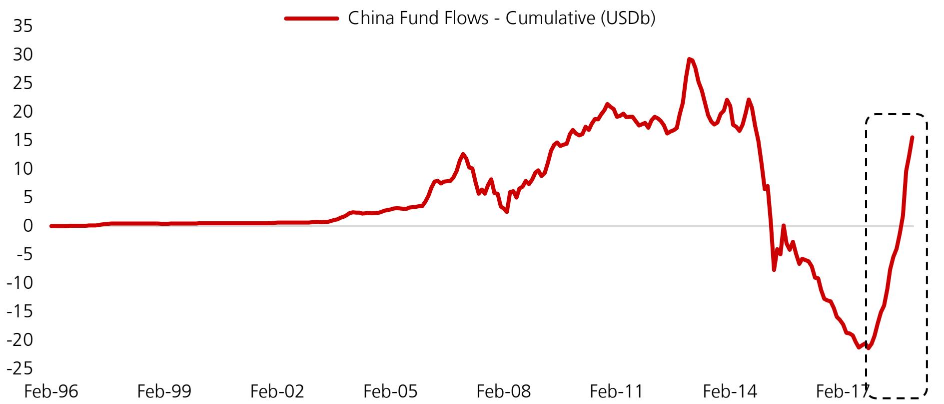
However, 2018 marked a turning point.

While DM registered only slight inflow of USD1.7b, EM equities saw significant net inflow totalling USD55.0b. Mind you, the net flow into EM was more significant if one takes into account the market capitalisation of DM being many times larger than EM. Indeed, investor sentiment has been on the rise after the Fed adopted a dovish tone in the December Federal Open Market Committee meeting, which in turn drove government yields south (Figure 4).

A sustained HSCEI rebound is clearly dependent on corporate earnings, and policy stimulus is a medium-term tailwind. Make no mistake. While positive fund flows augur well for the outlook of China equities, ultimately, corporate earnings have to deliver in order for the recent market rally to sustain. As Figure 5 shows, the Hang Seng China Enterprises Index (HSCEI) has been trending in tandem with China forward earnings. The latter has undergone a significant decline, given recent concerns on trade war and economic deceleration in China. We believe that at the current level of 8.1x forward P/E, a lot of the negative news flow has already been priced-in. In the coming months, we believe the Chinese government will implement policy measures to support the economy and this will be a net positive for corporate earnings.

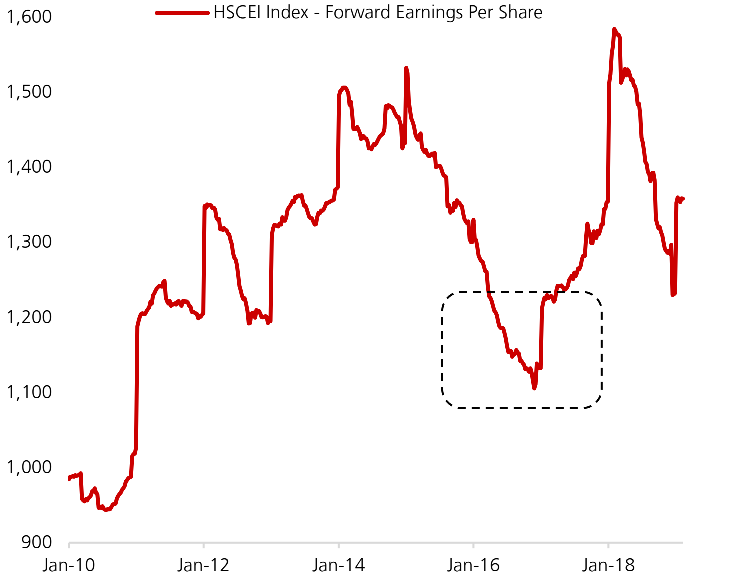
Adopt a barbell strategy; favour China equities for potential capital gains. As part of our barbell strategy – which entails heavy investment exposure at the low and high ends of the risk spectrum – we favour China equities for the latter. The sectors we find attractive are China Financials and Technology.

Figure 1: U-Turn – Fund flows to China have surged as sentiment rebounds



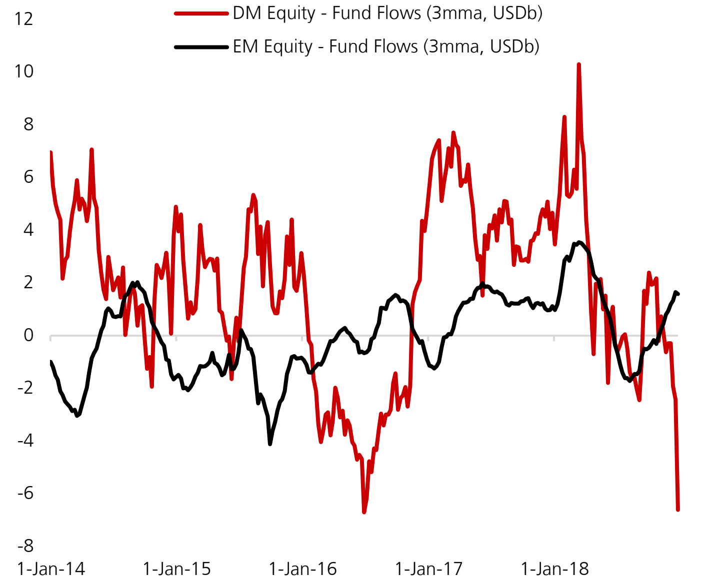
Source: EPFR Global, DBS

Figure 2: Investor sentiment on China bottomed in mid-2017, coinciding with the trough of domestic corporate earnings



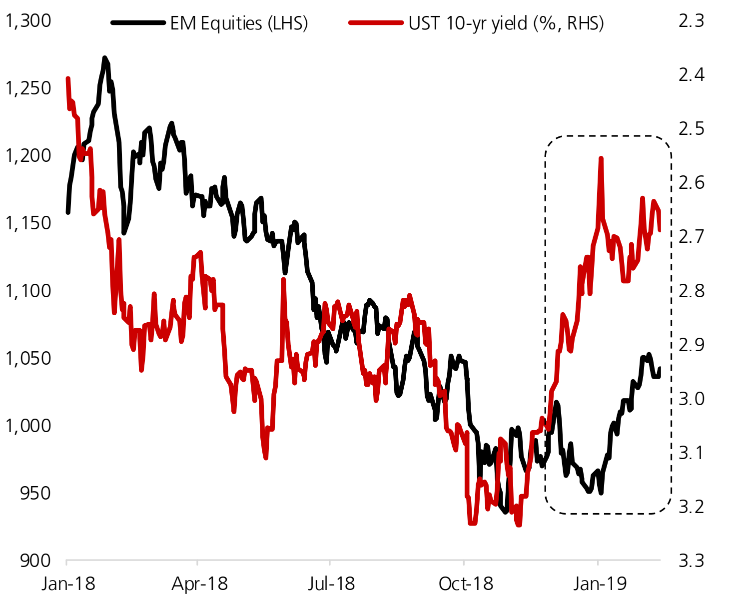
Source: Bloomberg, DBS

Figure 3: EM fund flows have been robust in 2018 as policy tightening by the US Federal Reserve falters



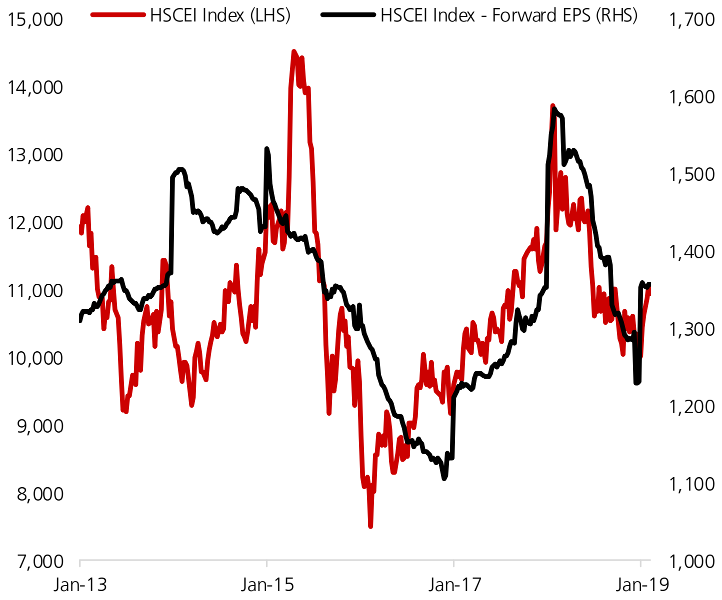
Source: EPFR Global, DBS

Figure 4: EM equities rallied as government bond yields fell



Source: Bloomberg, DBS

Figure 5: HSCEI is trending in tandem with China forward earnings



Source: Bloomberg, DBS

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