EQUITIES

Hong Kong-China Equities: Accelerating Areas of Opportunity

BARINGS INSIGHTS

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As COVID-19 slowly loosens its grip on China, it has become clear that many of the long-term structural trends shaping the markets remain intact or have even accelerated—creating investment opportunities in Hong Kong-China equities.

Chinese authorities have implemented targeted, large-scale monetary and fiscal policy efforts to counterbalance the initial shock from the pandemic, and China's economy has responded. The country reported economic growth of 3.2% in the second quarter—a strong rebound from the first quarter—and operating capacity across key sectors such as property, automobiles and technology returned to pre-COVID levels. The Hong Kong-China equity markets have followed suit, recovering notably in the last few months. And while pockets of volatility are very likely going forward, and much uncertainty remains around the severity and longevity of the crisis (and the virus itself), we believe the equity market remains supported and will continue to present attractive long-term growth opportunities for investors.

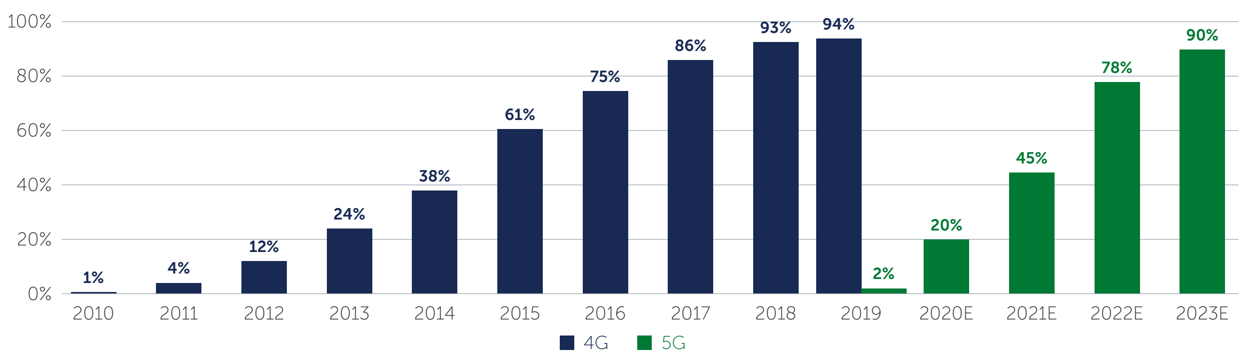
In particular, there are a number of sectors benefitting from supportive long-term trends that have accelerated amid global lockdown conditions—digital infrastructure, e-commerce and health care chief among them. In our view, companies that are directly or indirectly exposed to these sectors, and to the underlying trends supporting them, look poised for further growth as the economy recovers.

1. "New" Digital Infrastructure

New digital infrastructure—5G, artificial intelligence, industrial internet and big data centers, for instance—is one area where opportunities have increasingly emerged during the crisis. Specifically, data center operators , which were already on an upward trajectory, have experienced a significant boost from the prolonged work-from-home environment. With a greater amount of content being consumed online, data traffic has increased notably, resulting in a more urgent need for faster computing power. By some estimates, growth in China's data center market could accelerate by as much as 26% over the next three years—largely a result of the increased demand on the back of COVID .[1]

5G is another area that stands to gain significant momentum over the coming years—and with the launch of 5G commercial services by telecom operators in 2019, China has officially entered the 5G era. Of note, we expect 5G adoption to track materially faster than 4G—by some estimates, 5G-enabled smartphones could account for up to 90% of the smartphone market by 2023, or four years after entering the market[2]. While most 5G models have so far been restricted to premium or high-income segments of the market given the higher cost of components, new models continue to enter the market and will likely account for a growing proportion of new launches in 2020 and 2021[3].

FIGURE 1: Smartphone Penetration Rates (5G vs. 4G)



SOURCE: HSBC estimates, Barings estimates. As of June 2020.

As this technology becomes more widely accessible and continues to penetrate the market, businesses exposed to the growth will likely benefit. Specifically, those that manufacture the components required for 5G smartphones, such as chipmakers, look well-positioned—as do companies that manufacture smartphone antenna and cameras, which can be used to upgrade phones. Selective companies within the communication services industry are also likely to benefit, particularly from the 5G adoption trend and the surge in data utilization.

1. 26% of growth forecast between 2019 to 2023. Source: CAICT, Intelligence Research Group, Frost & Sullivan, IDC, Cisco, Gao Hua Securities Research. As of April 2020.
2. 90% adoption rate forecast between 2019 to 2023. Source: HSBC estimates, Barings estimates. As of June 2020.
3. Source: UBSe. As of June 2020.

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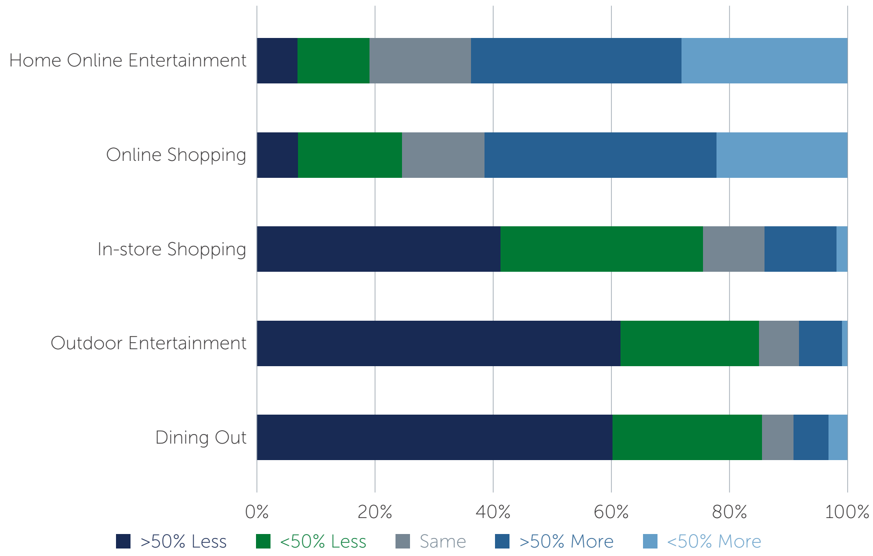
2. E-commerce

E-commerce is another sector benefitting from the rise in online consumption. While online retail sales in China were already on a positive and growing trajectory—having witnessed tremendous growth in recent years as consumer behavior shifted away from brick-and-mortar stores—the COVID-induced lockdown measures have accelerated this growth. With more people opting to order goods online—from food to clothing to entertainment—the growth in e-commerce has spanned nearly all sectors. Online grocery shopping, for instance, has surged, as even traditionally less-penetrated demographics such as seniors choose to purchase food online. Food delivery companies too, are benefitting, and estimates suggest the sector could grow from RMB581 billion in 2019 to RMB1.2 trillion by 2023[4].

FIGURE 2: Changes in Shopping and Entertainment
(Before and After the Pandemic)



SOURCE: UBS Evidence Lab, "China COVID-19 Impact Consumer Pulse Check Survey". As of April 2020. This survey of 1,000 consumers was conducted from April 1–April 6 across China and tracks the impact of COVID-19 on behavior.

Online shopping experiences are also becoming increasingly personalized, which should continue to buoy the industry going forward. With many storefronts closed, for instance, many franchises have begun offering virtual shopping experiences via livestreaming, which has driven additional user traffic to online storefronts. Indeed, we expect to see growth in the e-commerce livestreaming market reach RMB1,157 billion by the end of 2020, up from RMB451 billion in 2019. While businesses have certainly faced challenges as a result of the pandemic and global lockdowns, those able to capitalize on these new trends—and cater to a growing online user base—will likely be better positioned going forward.

4. Source: iResearch, Goldman Sachs Global Investment Research. As of September 2019.

3. Health Care

The ongoing urbanization in China, and the steady rise in household wealth over the last decade, have led to an increased focus on health and wellness—and COVID has certainly underscored the need for greater spending on the health care sector. In order to bring the quality of China's health care system up to a level comparable with that of its global peers, we expect the Chinese government to increase their support for health care companies going forward, through measures such as streamlining drug approval processes and modifying reimbursable lists.

In particular, we see growing opportunities in newer biotech companies. Many of these companies have greater exposure to international markets and a more global mindset—in fact, there is a very large pool of Chinese researchers and scientists that have been trained in developed markets. We believe this bodes well for the development of the industry. One example is a Suzhou-based biotech founded by an internationally trained Chinese chemist. The company was able to leverage its broader knowledge and familiarity with cutting-edge technology to successfully research, develop and commercialize one of the first immunotherapies to be approved by Chinese regulators—which resulted in very strong performance.

China's aging population, as well as the increasing disposable income of the country's middle class, will also likely create opportunities for companies with exposure to the health care sector. For example, consumers may be able to afford private health care, or buy health insurance—benefitting the companies offering such products.

FIGURE 3: Increasing Disposable Income of China's Middle Class

Annual Household Disposable Income 2018 Real RMB Terms		Urban Population in China (Million) 2010	2018
Global	>390k	6	16
Affluent	297–390k	3	10
Mass Affluent	197–297k	10	63
Upper Aspirant	138–197k	34	311
Aspirant	79–138k	403	257
Lower Aspirant	49–79k	134	89
Poor	<49k	79	72
Upper Aspirant and Above Population, % of Total		~8%	~49%

SOURCE: McKinsey Global Institute. As of December 2019.

The Takeaway

There are a number of risks on the horizon today—from the global pandemic to growing U.S.-China geopolitical tensions to the upcoming U.S. presidential election—and volatility is likely a given going forward. However, the current market also presents opportunities for stock pickers to capture fundamentally attractive investments, particularly in sectors benefiting from supportive long-term trends. That said, not all companies within these sectors are created equal, and some will inevitably fare better than others. In our view, companies with strong balance sheets and sustainable, long-term earnings visibility are best positioned to withstand today's challenges. For this reason, fundamental, bottom-up stock selection remains critical to navigating this space—not only for identifying good long-term opportunities, but also in terms of avoiding unwanted risks.

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