Aug 30 , 2016

ChinaAMC

ShenZhen-HongKong Connect

Another milestone achieved

Background

ShenZhen – HongKong Connect program was officially announced on Aug 16th. According to the implementation timetable been released by HKEX, the official launch is scheduled in four months pending further tweaking of the rules and market education and rehearsal.

Key Highlights

- **Aggregated quota ceiling has been abolished**

  There will be no quota ceiling for SZ-HK connect, meanwhile the quote ceiling for SH-HK connect has been abolished. However, daily quota of 13 Billion RMB (Northbound) and 10.5 Billion RMB (Southbound) stay the same. As a major step towards market and capital account liberalization, the abolishment of aggregated quota marks the de-facto opening up of the domestic stock market to global investors. It will no doubt boost the odds for MSCI inclusion decision in 2017.

- **Southbound investable universe to include more small cap names**

  Eligible stocks for northbound trade are constituents of the SZSE Component Index (399001.SZ) and the SZSE Small-/Mid-cap Innovation Index (399015.SZ) with market cap > RMB 6 Billion, as well as all A/H dual listed companies (872 stocks in total). Southbound trade will add 115 constituents of the Hang Seng Small-cap Index (HSSI Index) with market caps of more than HKD 5 Billion. Over 70% of A share and HongKong market cap become accessible combing SH-SZ-HK. (Exhibit 1)

- **ETF might be included in the investable universe**

Exhibit 1: Over 70% of A share and HongKong market cap become accessible

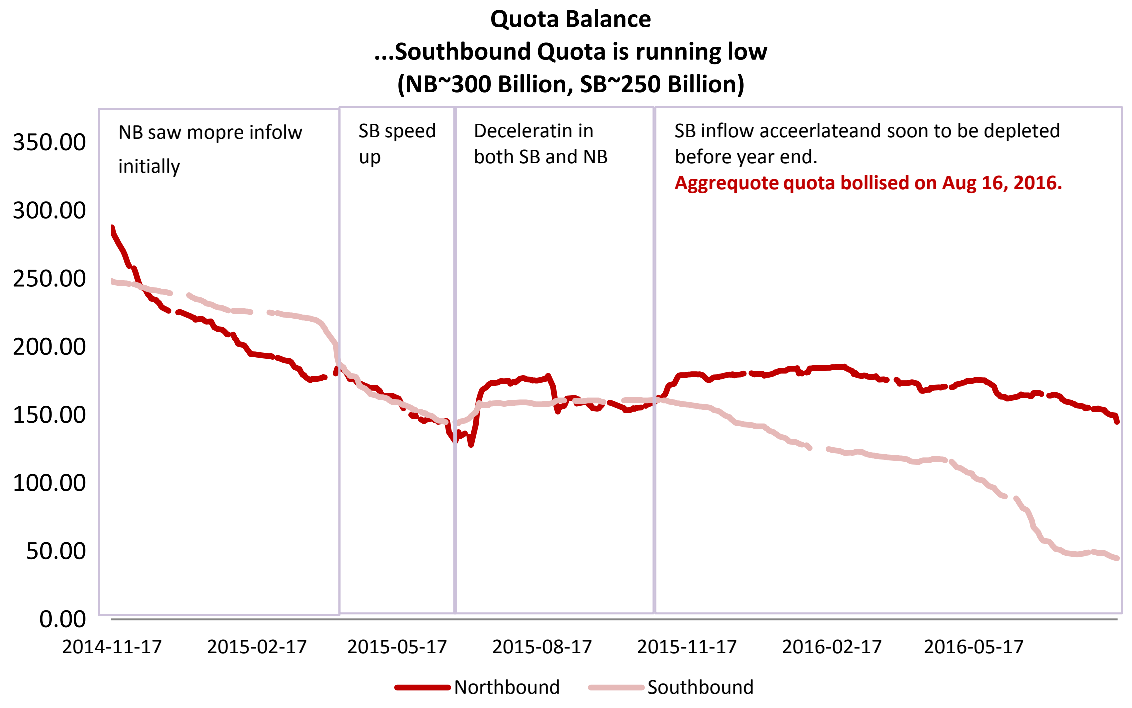
Markets	Constituents (No.)	Constituents (%)	Daily Average Volume (YTD)	Average Volume (%)	Market Cap （%)
SH-HK Connect	567	51.1%	1360	67.5%	**85.9%**
Shenzhen Connect (Est)	872	48.8%	2280	68.3%	**74.2%**
HongKong Connect (Est)	438	22.5%	335	90.3%	**73.2%**
Shanghai A shares	1110		2015		
Shenzhen A shares	1787		3337		
HongKong Aggregated	1944		371		

Source: CICC

Short term: Hongkong sees inflow amid overseas allocation needs

There is strong desire for domestic investors to buy offshore assets, driven by RMB depreciation expectation, and exacerbated by the suspension of QDII quota approval since April 2015. Before the announcement, the Southbound balance had less than 20% remaining, and is expect to run out by year end. (Exhibit 2) But gladly, the abolishment of aggregated quote has solved this issue once and for all.

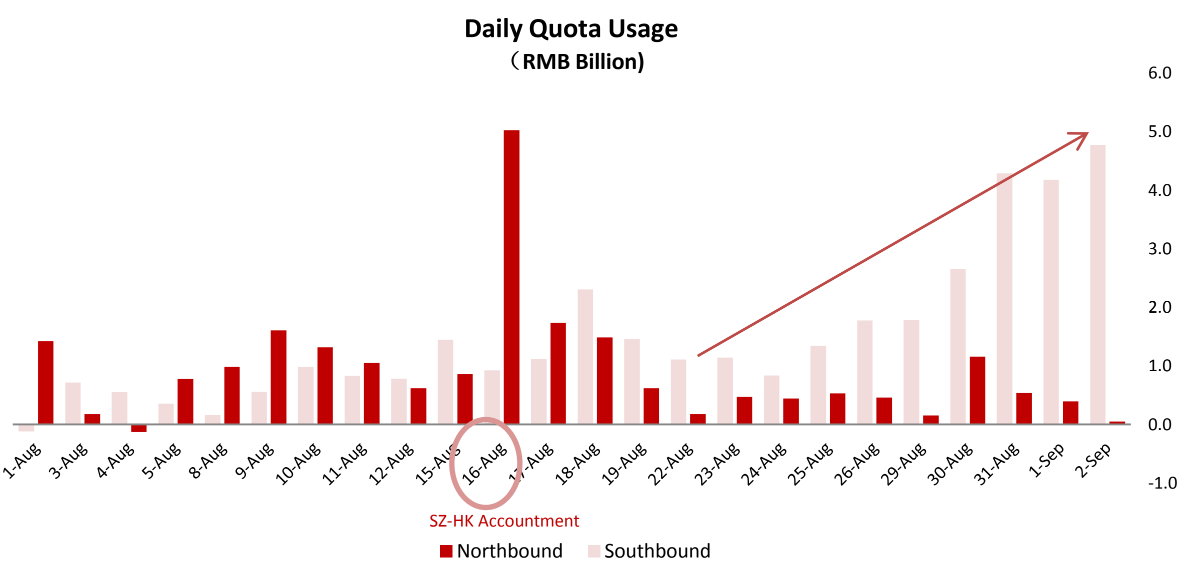
Exhibit2: SH-HK Connect in hindsight…Southbound catching up



Source: Wind, ChinaAMC as of Sep 5, 2016

Since the announcement on 16th, southbound daily quota usage has been picking up rapidly. (Exhibit 3)

Exhibit3: Southbound quota usage pick up significantly since SZ-HK connect announcement



Source: Wind, ChinaAMC as of Sep 5, 2016

Medium to Long Term: A game changer

In a medium to long term time frame it will reshape the capital market structure and ecological system of greater China.

- **"Greater China" Strategy will prevail**

Back in March 2015,fourth month after the launch of SH-HK connect, CSRC has approved domestic mutual funds to participate the connect program. As the onshore and offshore stock market become more integrated with over 70% of market cap on each side become tradable, asset managers are ramping up their expertise to roll out new strategies to capture the opportunities set.

- **Further Market integration between mainland and HongKong**

With the major obstacle of aggregated quota now out of the way, we expect the two markets to further converge and consolidate in terms of pricing mechanism, risk appetite and investor composition.

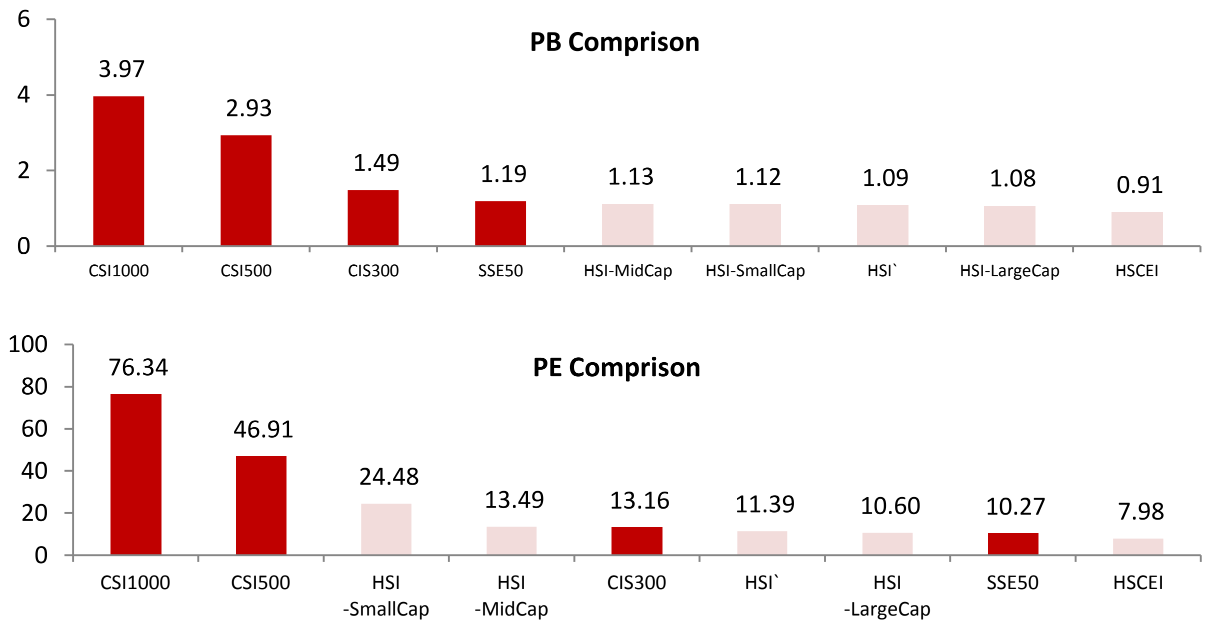
- **Domestic market regulation to be improved by global participation**

Amid greater participation from global investors, domestic regulatory framework and mindset will also have to be renewed to adapt to the changes. It will serves in the interests of A-shares, as it will face the test of MSCI inclusion again in June 2017, if not earlier.

Opportunities

In the near term, HK market has an edge in terms of valuation. (Exhibit 4) With 0.9X PB and 8.0X PE, major HK index such as the HSCEI is almost at its all time low. That could also be attributed to its close correlations to the global markets and had suffered from dual shocks earlier half of 2016 by the pulling out of Oil dollar and the looming US rate hike.

Exhibit 4: HongKong Markets look attractive from a valuation point



Source: Wind, ChinaAMC as of Sep 5, 2016

Reckoning the difference in A-shares and HongKong market, A/H index, which gauges overall premium/discount of the dual listcos could serve as the relative valuation barometer for the two markets. (Exhibit 5) The index seems to have traded with a band of 100 to 140, with below 100 the undervalued zone. This index also coincides with trough and peaks of the A-share markets such as in 2007. The law of mean-reversion also seems to apply to the A/H index, however, the reversion could take years to take place, as evidenced in 2010-2014.

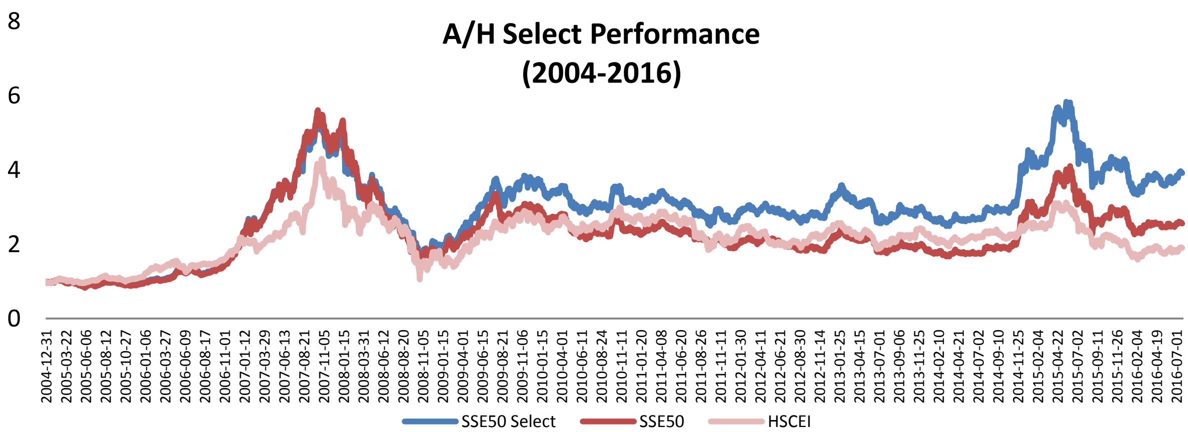
Exhibit5: A/H index speaks volumes for long term relative valuation

Source: Wind, ChinaAMC as of Sep5, 2016

We see opportunities in both H-share names as well as in A-share names. Value and scarcity still dictate our preference. HongKong small caps may be favored for their valuation being merely half of their domestic peers. For A/H names in HongKong, we like names with huge A/H premiums (H shares trading in discount) and those names from scare sectors such as healthcare. Following the same logic, in A-shares, we like names with wide A/H discount and low valuations also high dividend yields.

The unique A/H dual listing structure also allows for cross-market plays. ChinaAMC has coined its pioneering **ChinaAMC A/H Select strategy.** Unitizing replication technique, this strategy seeks to outperform the SSE 50 AH index by dynamically tracking the cheaper of the A/H dual listed constituents. This strategy has significantly outperformed both the standalone SSE 50 and HSCEI from 2014 to 2016. (Exhibit 6)

Exhibit6: ChinaAMC A/H Select LOF



Source: Wind, ChinaAMC Backtested results

Disclaimer

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