Deutsche
Asset Management

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PASSIVE INSIGHTS

SPOTLIGHT: CHINESE EQUITIES - WILL FLOWS FOLLOW PERFORMANCE?

EXECUTIVE SUMMARY

Within Equities, China remains as one of our key long ideas. In addition to a decisive year-to-date outperformance, the highly publicized inclusion of Chinese A-Shares into MSCI'S Emerging Markets indices has captured investor's interest. Fundamentally, Chinese stocks are neither cheap nor do they offer an above average dividend, but their earnings outlook is one of the strongest globally. Moreover, having exposure to Chinese indices will allow investors to have exposure to some of the largest and, arguably, most successful technology stocks in the world. Economically, the fear about a Chinese hard landing has eased. By stabilizing the Yuan, China surprised markets by successfully stabilizing capital outflows this year, easing fears of a hard landing. Moreover, various political reforms and initiatives such as the "Silk Road" project are laying the ground for future GDP and EPS growth.

Reforms have paid off – more to follow

Hard landing unlikely due to Yuan appreciation

Attractive earnings outlook

HEATMAP: CHINESE EQUITIES

Performance vs MSCI ACWI

1M	3M	1Y
3.6%	11.7%	16.9%

MSCI China, projected EPS growth

2018 vs 2017	2019 vs 2018
14%	15%

Valuation

MSCI China P/E ratio (historical percentile since 04/05) vs MSCI ACWI

14.4 (80%)	16.8

Source: Bloomberg Finance L.P. As of September 2017.
Past performance is not indicative of future returns.

Upcoming trigger events:

- 19th National Congress of the Communist Party of China on 18th October
- National People's Congress in March 2018

PERFORMANCE AND FLOWS

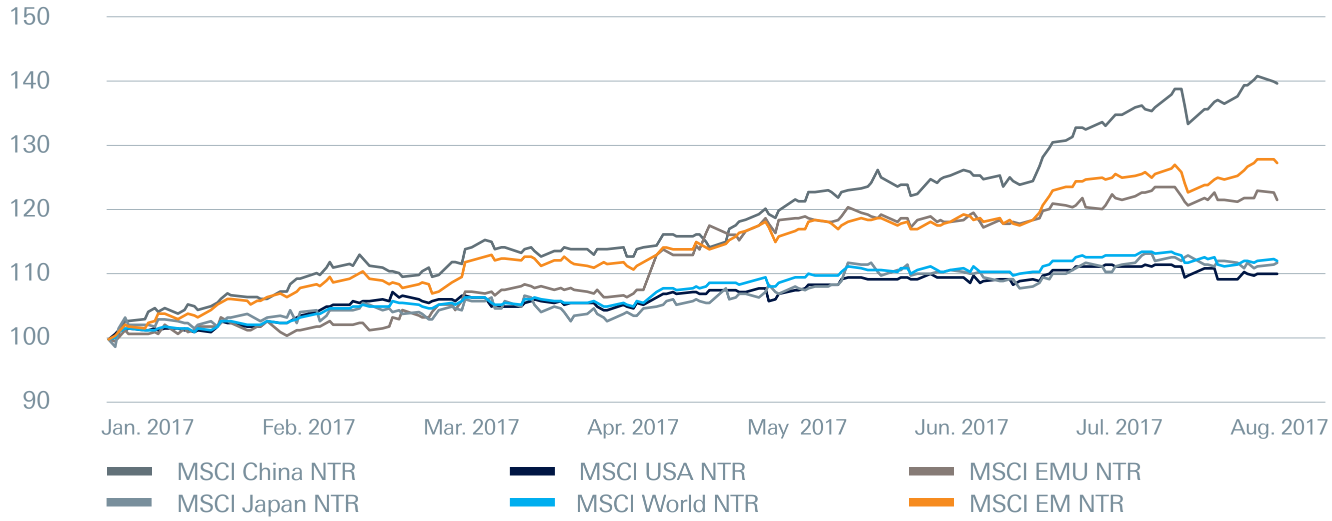
Performance

Following the summer break, we offer a recap of the latest market action, focusing on the relative performance of Chinese stocks against other Emerging (EM) and Developed Markets (DM) stocks.

In early March, DM equities reached their highest point in euro terms, but slipped thereafter due to the subsiding "Trump" effect and a concurrent depreciation of the US dollar (the euro appreciated by more than 13% against the US dollar between March 1st and the end of August). In contrast, in US dollar terms, markets barely paused as the euro started to appreciate and have since reached new all-time highs. Chinese and EM equities gained particular momentum from the spring onwards, outperforming most other markets and reaching new highs even earlier.

Chinese stocks outperform both DM and EM YTD

Performance in USD: YTD



Source: Bloomberg Finance L.P. As of August 2017.
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China's year to date performance has been driven by strong fundamentals, recently announced reforms of state-owned enterprises (SOEs) and economic restructuring plans, all of which should be supportive for the economy's long term growth prospects.

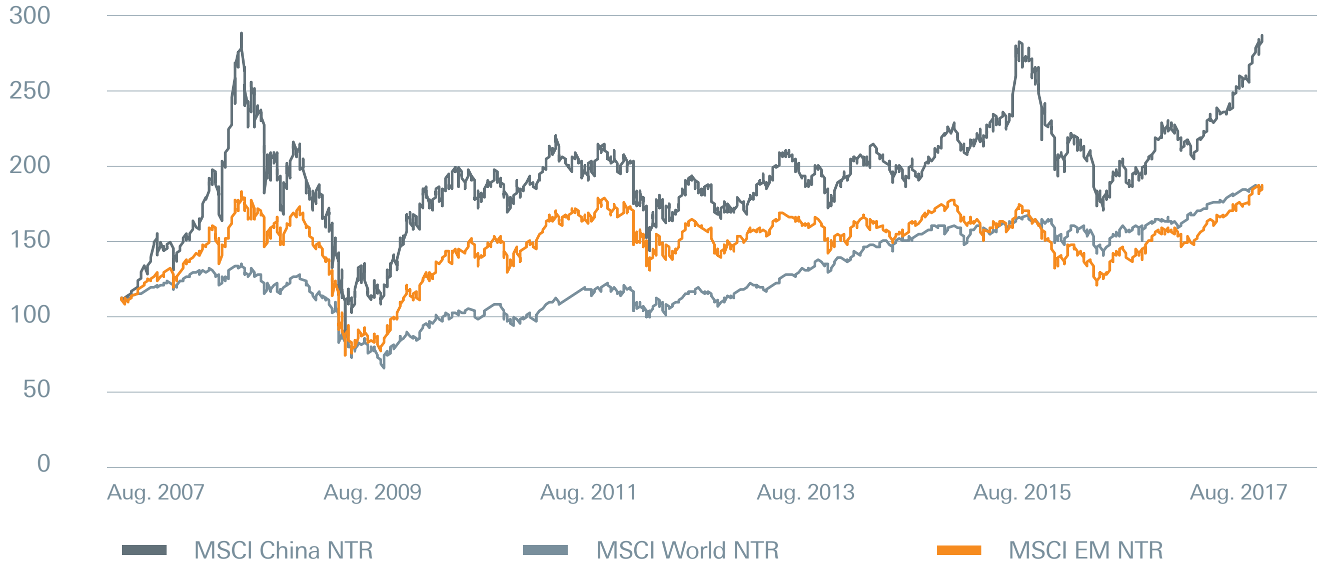
As at the end of August, the MSCI China index is up 41.69% in the year to date and is clearly outperforming both EM and DM equities: at the same date, EM equities had gained 28.29% in 2017 and had themselves outpaced their developed market peers by a wide margin.

The long-term performance of the MSCI China index is also impressive. Since August 2006, the index has risen by 188.88%, far exceeding the returns of its EM and DM peer indices. As evidenced in the performance table and chart below, this return has come at the expense of outsized share price volatility. Based on the historical evidence, Chinese stocks offer interesting performance potential, but timing is everything since the market's drawdowns can be dramatic.

Aug. 2006 – Aug. 2017	MSCI China NTR	MSCI EM NTR	MSCI World NTR
Annualized Return	9.99%	5.58%	5.51%
Annualized Volatility	28.23%	20.59%	16.98%
Sharp Ratio (vs. 0%)	0.35	0.27	0.32
Maximum Drawdown	-73.30%	-65.25%	-57.82%

Source: Bloomberg Finance L.P. As of September 2017.
Past performance is not indicative of future returns.

Performance in USD: August 2006 - August 2017



Source: Bloomberg Finance L.P. As of August 2017.
Past performance is not indicative of future returns.

The future prospects of Chinese equities are likely to be supported by the inclusion of A-shares in the MSCI EM Index. The consequences of this change could be higher institutional participation in the Chinese equity market, enhanced market efficiency and a reduction in volatility.

According to MSCI, approximately 450 large- or mid-cap A-shares could be included in the MSCI EM index in the future, implying total inflows of $ 340 bn into the index by August 2018. The inclusion of A-shares by MSCI could thus be a catalyst for further outperformance by Chinese blue chips.

Flows

Cumulative Net Onflows in MSCI China UCITS ETFs (EUR, Mn)

Source: Bloomberg Finance L.P. As of August 2017.
Past performance is not indicative of future returns.

Unfortunately, ETF investors have largely missed out on the opportunities in Chinese stocks. Over the past year, the assets invested in European ETFs following the MSCI China index increased by only € 78 m. Meanwhile, over the past five years, the assets invested in the largest UCITS Chinese equity ETFs have fallen by € 2.1 bn. This rather poor picture for index-based ETFs could be explained by a preference amongst investors for actively managed funds and for direct investments, particularly into the shares of the well-known Chinese tech giants.

ECONOMY: MACROECONOMIC REVIEW

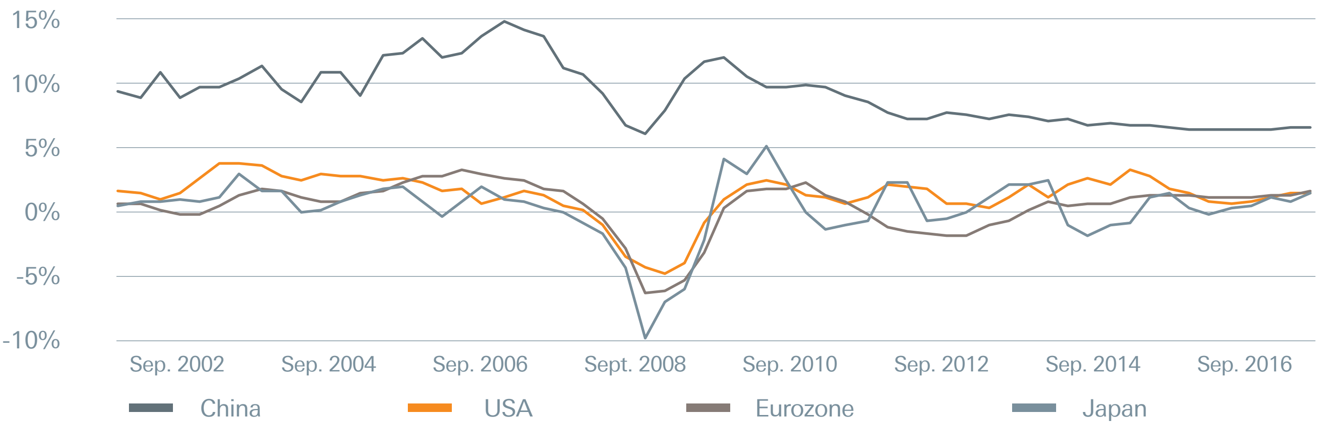
GDP growth re-accelerating

While the GDP growth rate in China has historically been higher than that in developed markets, the recent soft patch in China has also had a significant impact on the region. At around 6-7% currently, annual GDP growth in China is far from the double-digit levels achieved a decade ago. Still, it's more than three times the growth rate of major developed economies.

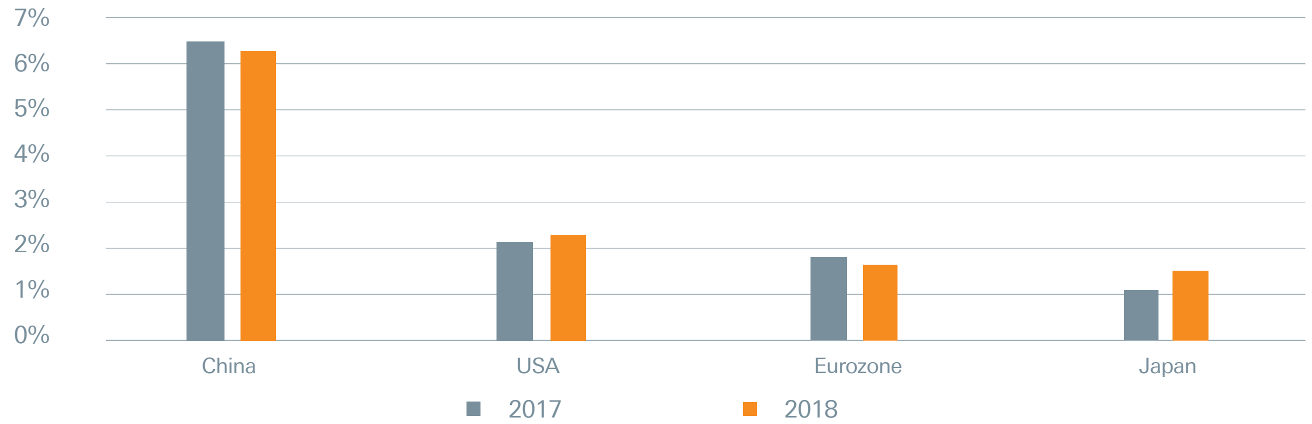
However, most economic indicators in China have recently exceeded our expectations, leading us to revise our GDP growth forecast for 2017 from 6.5% to 6.7%, and from 6.3% to 6.5% for 2018. This improving trend reflects a strong global environment, as well as structural domestic improvements. Support also comes from the Chinese political front: the 19th Party Congress will be held on October 18 this year and sensible changes in personnel amongst the country's leadership are anticipated, helping keep the GDP growth rate relatively stable.

China's GDP growth still at three times the rate of major developed countries

GDP Growth YoY: September 2002 June - 2017



GDP growth rate outlook

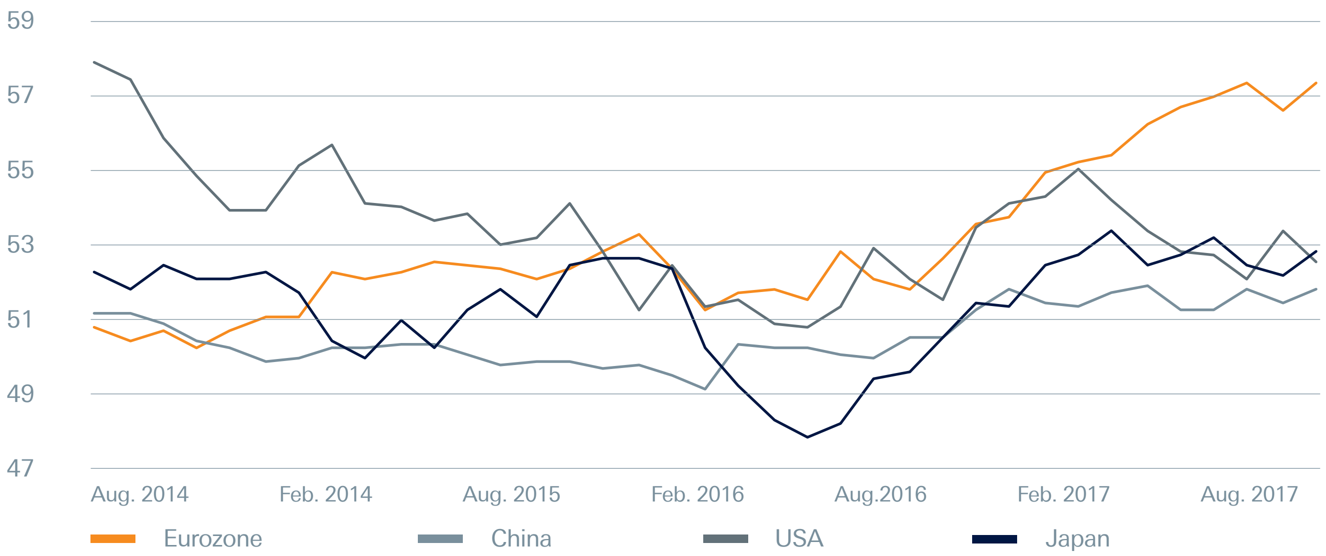


Source: Bloomberg Finance L.P. As of August 2017,
Deutsche Asset Management Investment GmbH, as of June 2017.

Leading growth indicators, like the purchasing managers' index (PMI), are pointing towards a somewhat muted growth profile for the Chinese economy, however. A lot of that sluggish momentum can be explained by a bifurcation into booming and contracting parts of the economy. While the consumption of household goods and automobiles remains strong in China, the rate of increase in property prices has slowed markedly due to the deleveraging policy of the Chinese central bank, the PBoC, even though house price rises remain in positive territory year-on-year. Consequently, all housing-related sectors are contracting, weighing on the PMI.

Chinese growth outlook split into booming and contracting parts of the economy

Manufacturing PMI: August 2014 - August 2017

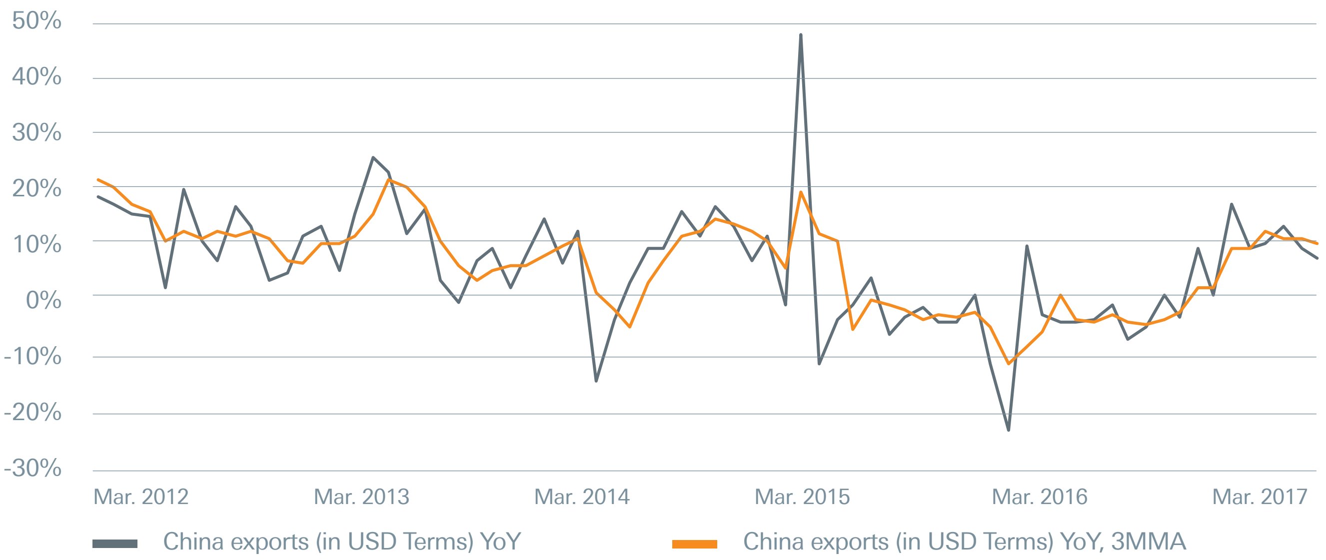


Source: Bloomberg Finance L.P. As of September 2017.

Exports & Consumption

The August trade data from China's Customs Bureau gives support to a continuation of the recent solid expansion in export volumes. The export orders sub-index in the Caixin PMI edged up to 54.6 from July's already elevated index level of 53.5. Stronger import demand in the US and Europe, as well as the continuing absence of US tariffs (despite all the protectionist talk from Washington), are supporting China's overseas sales. However, continuing strength in the Yuan will start to take the edge off China's competitiveness, if it is sustained.

China exports growth



Source: Bloomberg Finance L.P. As of September 2017.

Private consumption in China has grown robustly during recent years after wage growth exceeded the rate of growth in GDP. Given the stable economic outlook, consumers have also become more confident: China's consumer confidence index reached 114.6 in July, a record high for the past 20 years.

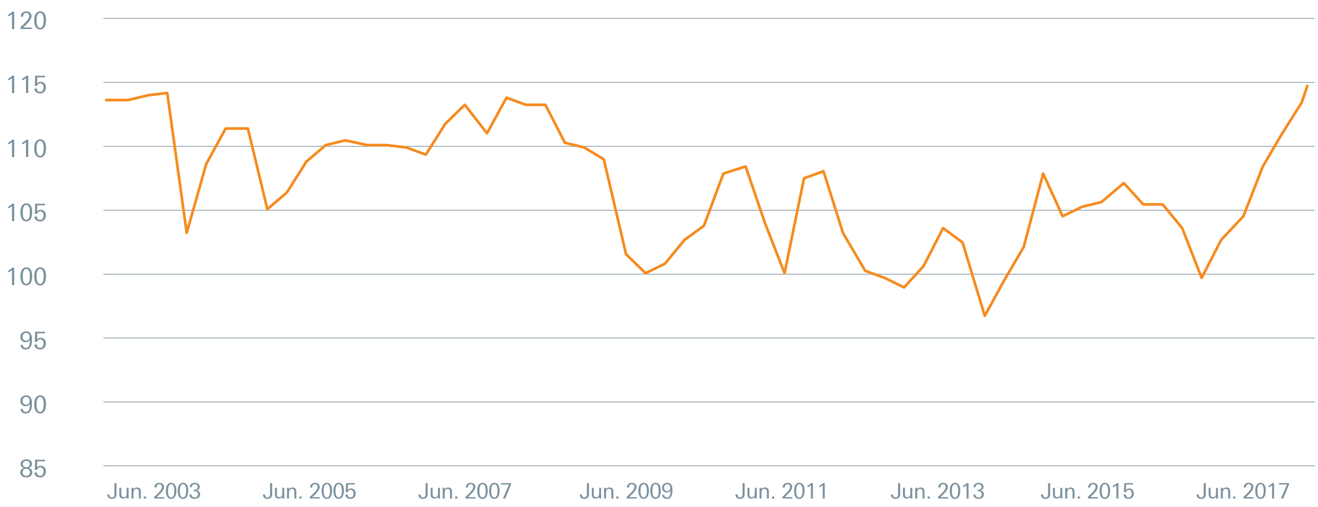
The consumption boom also seems to be focused on luxury goods and imports more than on staples, which are largely domestic in production. The National Bureau of Statistics issued a note to comment on July's retail sales and one point they made is that the consumption of SUVs and entertainment rose much faster than total retail sales.

The momentum in consumption seems to be driven by a wealth effect resulting from the recent property bubble. This wealth effect was not significant at the macro level before 2016, because until that date property prices had recorded significant gains only in tier-1 cities (representing 8.9% of the overall urban population). However, as the bubble has spread into tier-2 and satellite, tier-3 cities (representing 63.4% of the urban population), a larger share of the Chinese population has been affected.

Structurally, the ongoing reduction in the Chinese savings rate should lead to an increase in the consumption component of GDP. Higher consumption should provide a stabilising internal factor for GDP growth and make it less dependent on exports.

Consumer confidence has risen to the highest level since the turn of the century

China Consumer Confidence Index



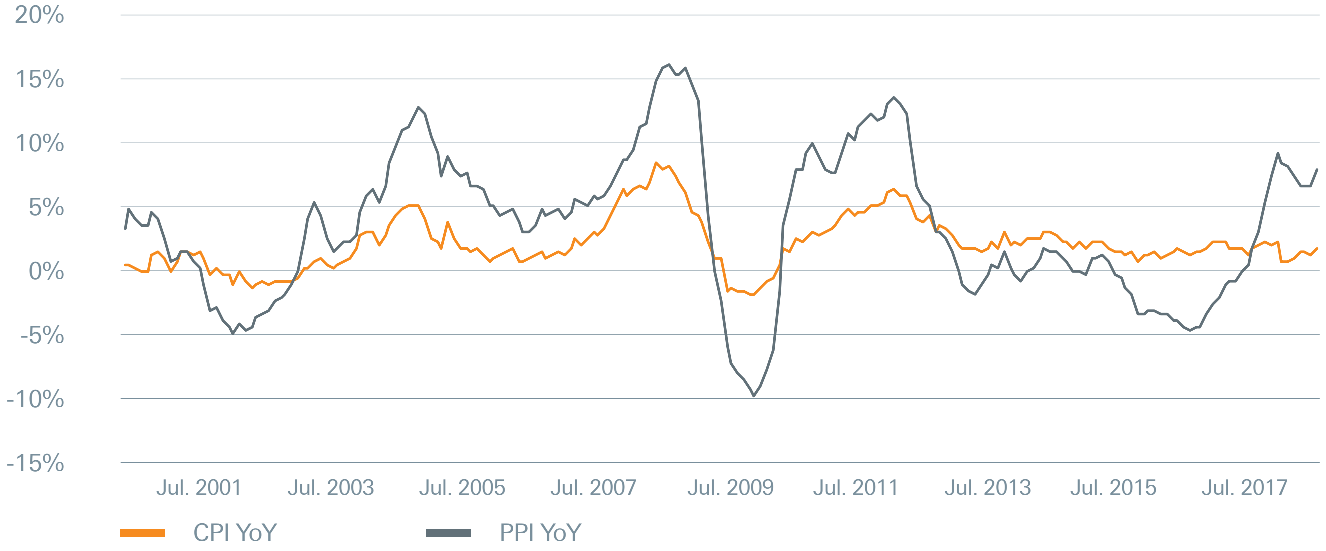
Source: Bloomberg Finance L.P. As of August 2017.

Inflation still muted

Although the Chinese state had started two years ago to take steps to reduce industrial overcapacity, this remains an issue in such sectors as steel and aluminium production, electric power and shipbuilding. Directed government actions should help in the short to medium term to improve the situation further. The shutting down of excess steel and aluminium production capacity has recently led to a recent sharp recovery in base metal prices. Consequently, the producer price index (PPI) has increased substantially for several months in a row, boosted by increases in the prices of steel, non-ferrous metals, as well as oil and natural gas. The acceleration of producer prices is a significant positive sign for China's economy, since it should help drive profits higher and enable companies to process their debt burdens a little more easily.

Stable consumer prices and increasing PPI likely driving future profit growth

CPI and PPI (yoy,%)



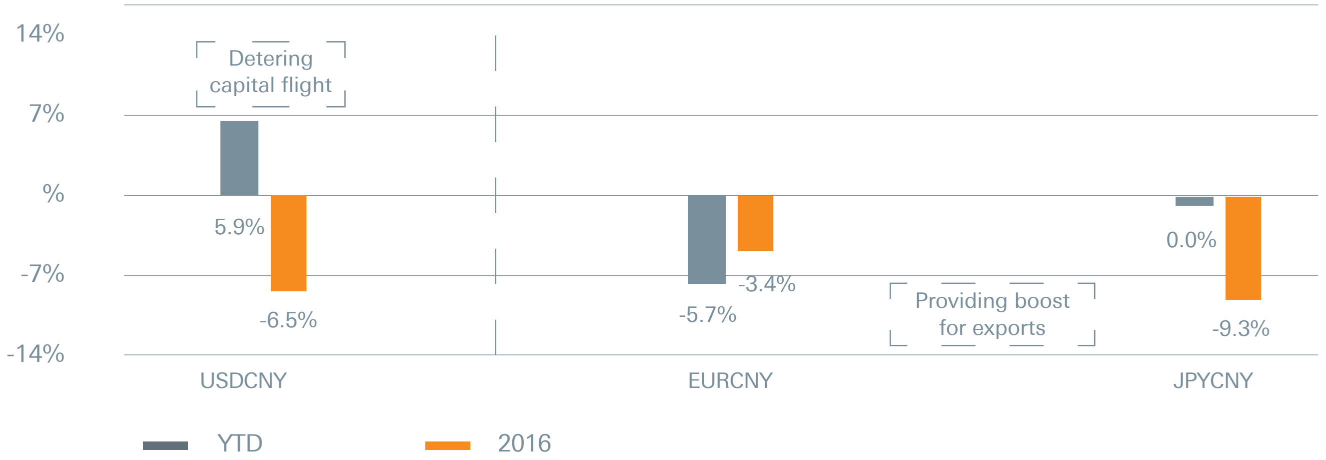
Source: Bloomberg Finance L.P. As of September 2017.

Currency: Yuan appreciation a win-win for China and the US

The appreciation of the Yuan has been an important support for growth this year, for two reasons: the sharp rise in the Yuan/dollar exchange rate has curtailed capital flight; and the weak dollar has depressed the value of Yuan versus other currencies, such as the Japanese yen and the euro, helping boost Chinese exports to those currency regions.

Yuan exchange rate: Deterring capital flight while boosting exports

Performance of Yuan vs. USD, EUR and JPY



Source: Bloomberg Finance L.P. As of August 2017.
Past performance is not indicative of future returns.

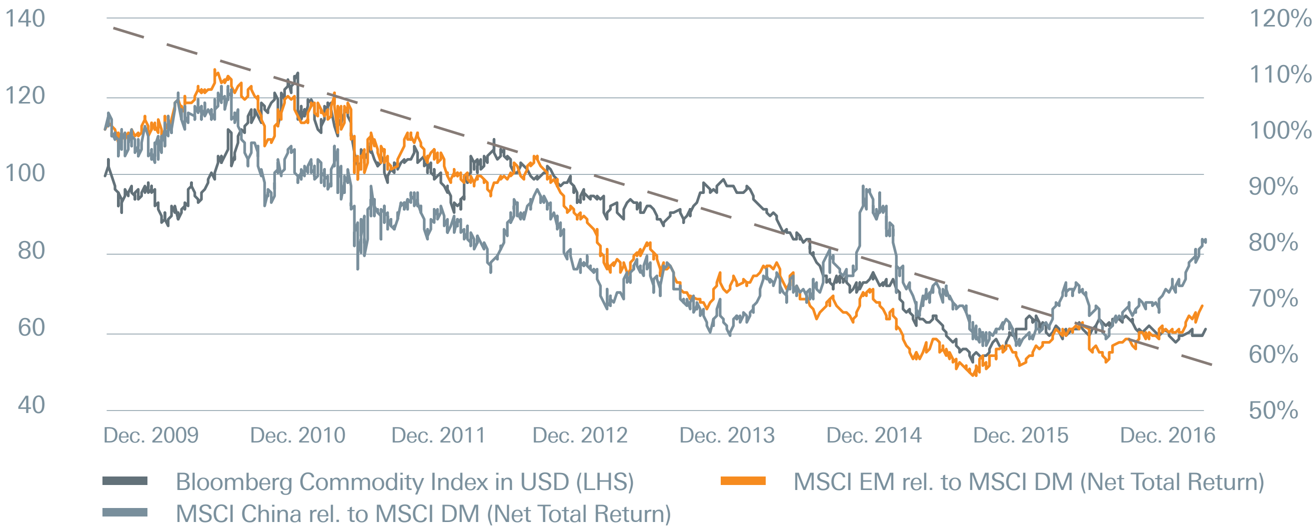
In addition, the strength in the Yuan versus the US dollar has helped reverse a sharp drop in China's FX reserves, while having little negative impact on trade with the US (since trade with the US is largely invoiced in dollars).

Commodities: Still determining relative performance?

In the last couple of years we have witnessed some decoupling of the performance of Chinese equities from commodity prices. However, it's evident that commodity prices remain a pivotal factor for the overall relative performance of EM equities. The Chinese authorities have focused on reducing levels of overcapacity in commodity-heavy industries such as steel and aluminium, helping to increase profitability in those sectors. As a side effect, this policy has also helped put a floor under commodity prices and helps explain the recent rebound in the relative performance of both EM and Chinese stocks with respect to DM equities.

Stabilization of commodity prices supportive of further relative outperformance

Commodity prices and relative EM & Chinese EQ performance



Source: Bloomberg Finance L.P. As of September 2017.
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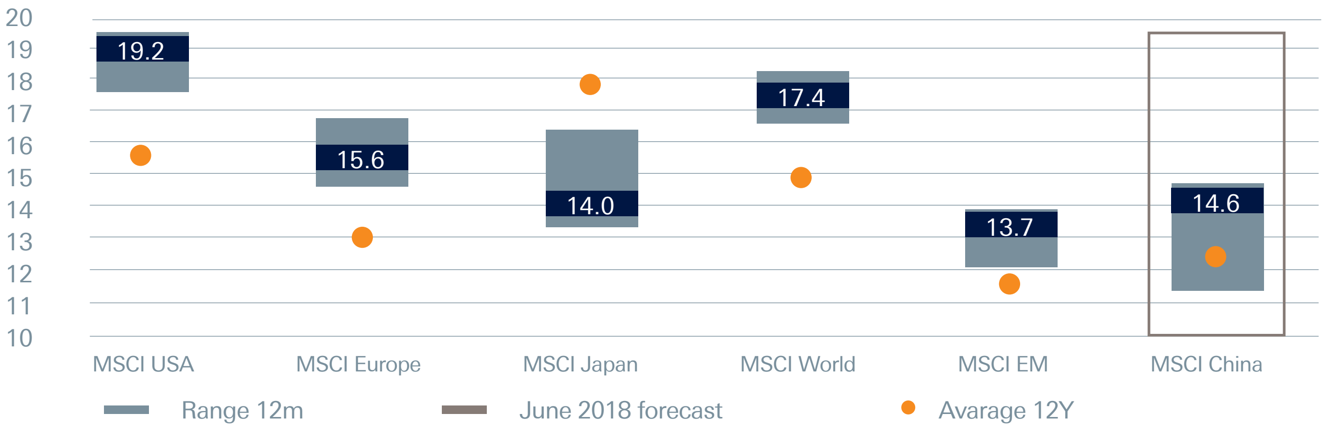
FUNDAMENTAL INDICATORS

Valuations elevated

Chinese stocks appear to be reasonably priced compared to most developed markets, especially the USA, but are on average a bit pricier (on the basis of the forward P/E ratio) than other EM peers. Given the strong appreciation Chinese equities have experienced over the past 19 months, the notion that Chinese PE numbers are above historical averages does not come as a surprise.

Most markets look expensive on forward P/E

P/E ratios (based on F1Y earings estimates)



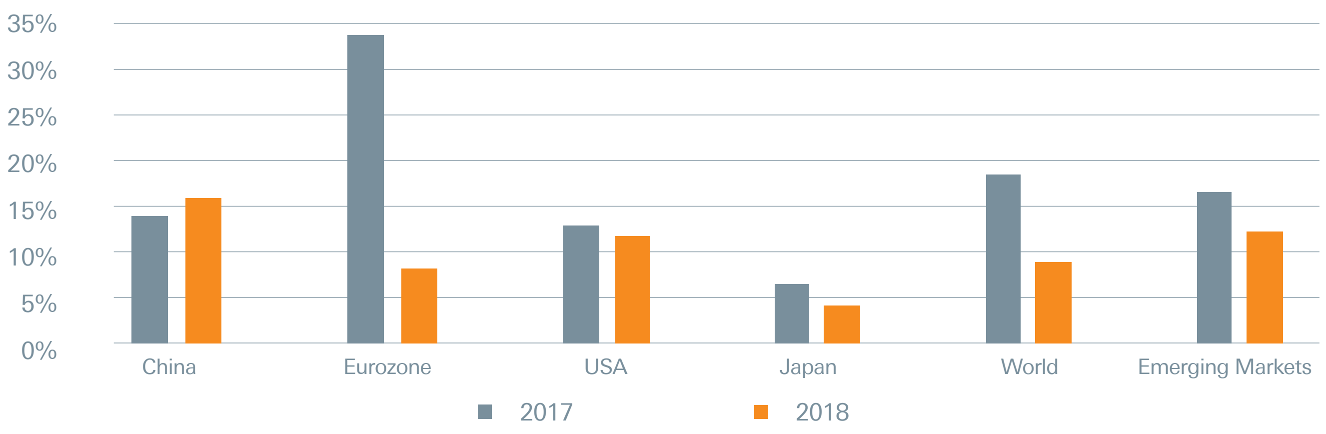
Source: Bloomberg Finance L.P. As of September 2017.
Past performance is not indicative of future returns.

Earnings growth accelerating

Overall, earnings growth is accelerating from last year and reported earnings numbers have largely been welcomed by markets. Notable earnings beats have been reported in the IT, financials and real estate sectors. Important earnings improvements were also visible across coal, oil and metals and mining. These sectors have benefited from the recent stabilisation in commodity prices and from a reduction in industrial overcapacity.

Chinese EPS growth continuing into next year

EPS Forecasts

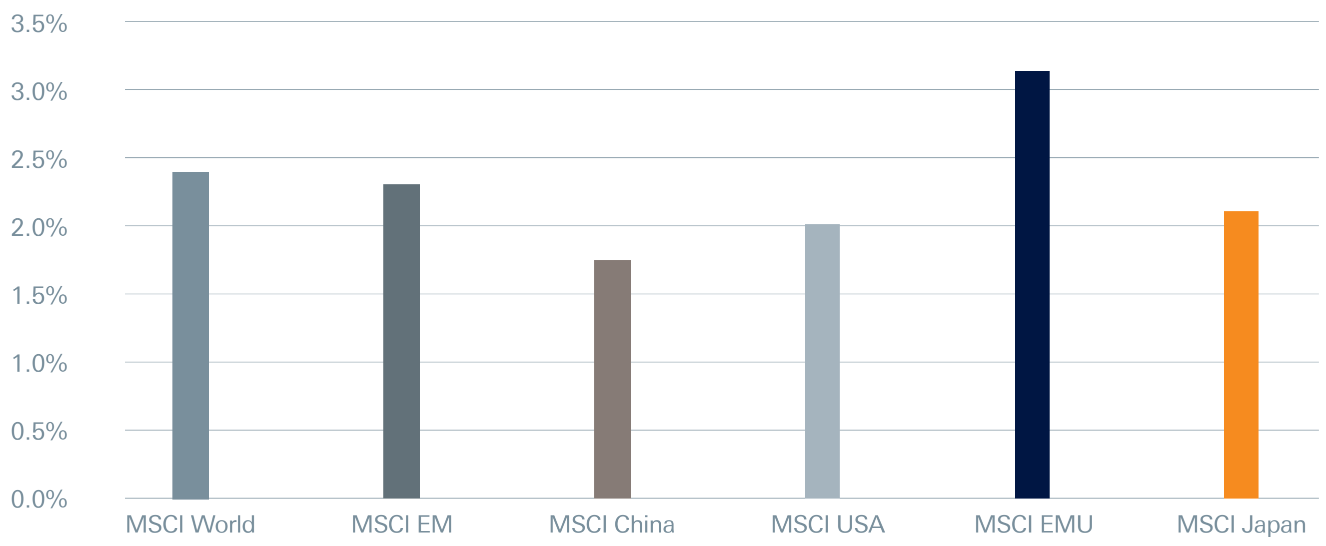


Source: Bloomberg Finance L.P. As of August 2017.
Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect

Dividend yield still somewhat below other regions

The average dividend yield in MSCI China is still behind that of most other regional indices

Dividend Yield



Source: MSCI Inc. As of August 2017.

Debt still high but not indicative of crisis

The ratio of China's total debt to GDP was 258% at the end of 2016, an undoubtedly high level given China's stage of economic development. At the central government level, debt is not really a problem, at 37.6% of GDP; what is remarkable is the speed of increase in the debt of the SOEs and local governments.

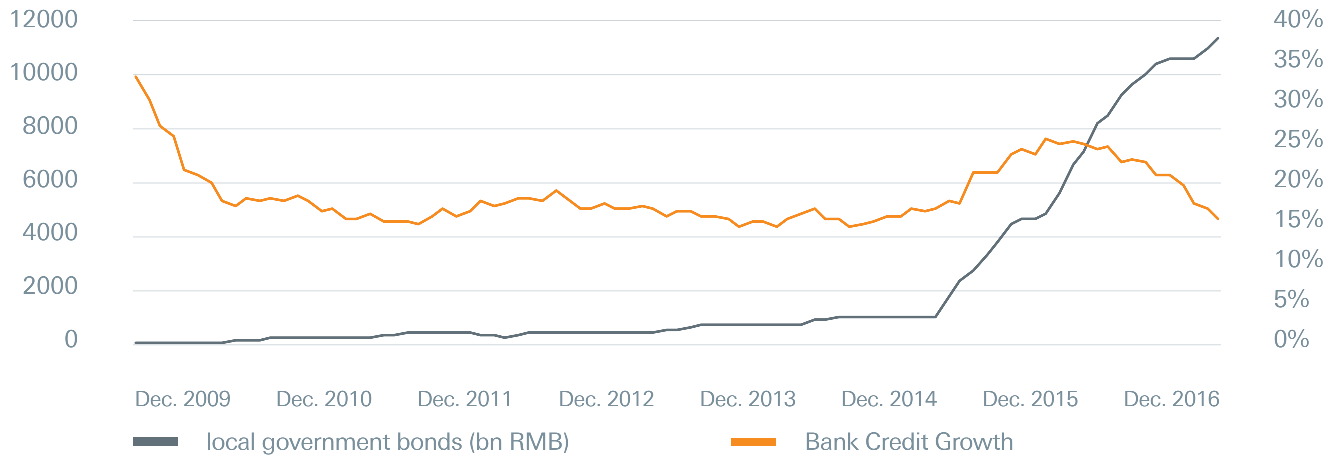
While China's overall debt levels are high, by itself this does not make a near-term debt crisis inevitable. This is because:

- China's capital account is not open and most debt is held by domestic investors;
- The majority of the corporate sector has a low debt level, but there are highly indebted and inefficient companies, in particular SOEs;
- The debt level of local governments has increased sharply, but the increase is likely going to be smaller in the coming decade;
- Among the SOEs most of the manufacturers are not highly indebted and the potential debt problem is confined to certain sectors, notably China Railway, the coal and steel industry, the building materials, ship building and property sectors, all of which are undergoing restructuring.

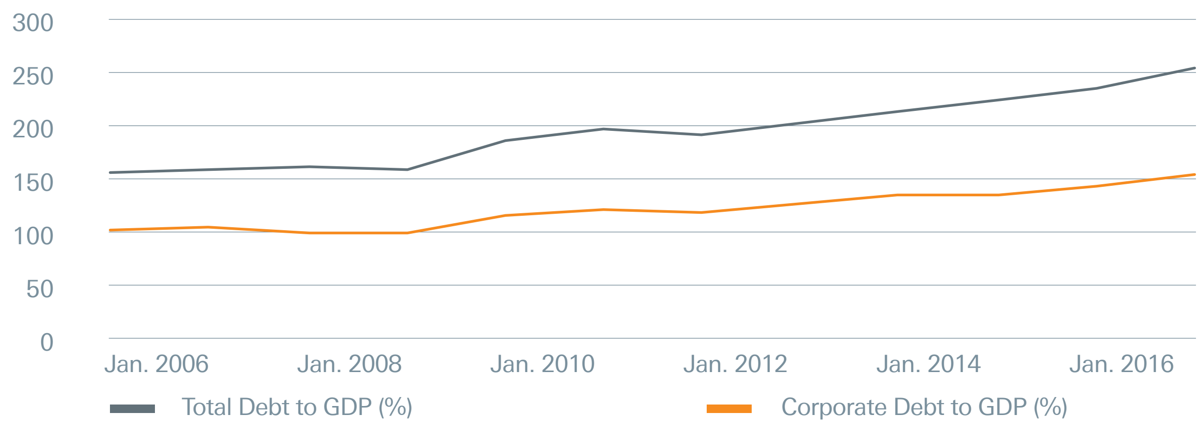
Much of the local debt explosion has been infrastructure-related. Under a new regulation that entered into force in 2015, local governments have to replace private debt with bonds, leading to greater transparency. And China is reforming its tax system to allow local governments more revenue sources to match their spending.

Overall debt levels still on the rise

More transparancy in Local Government Debt



Debt to GDP (%)

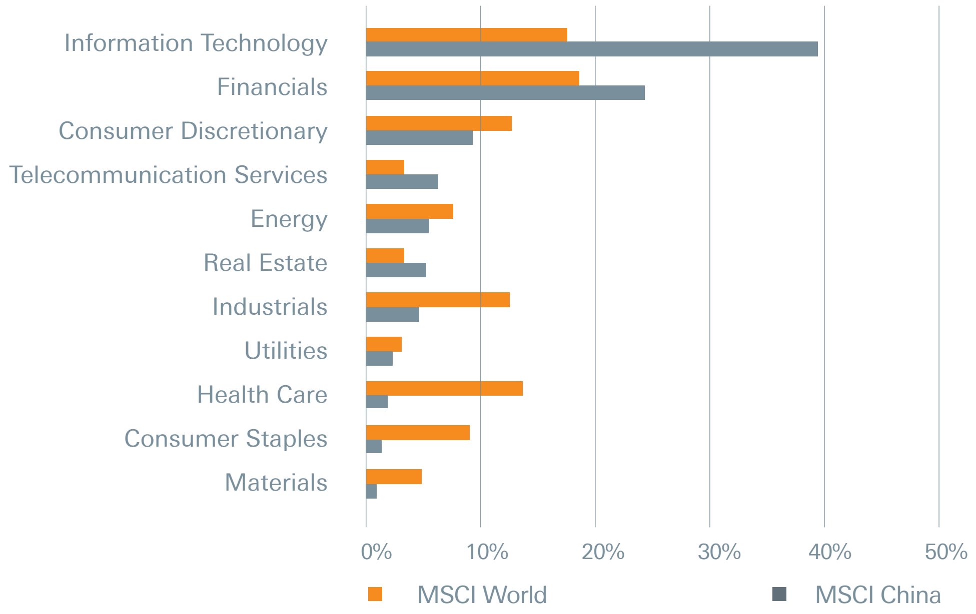


Source: Bloomberg Finance L.P. As of September 2017.

Sector breakdown

With a 40% weight at the end of August 2017, the IT sector now represents the largest slice of the MSCI China index. The sector returned 71.93% over the first eight months of the year, compared to 41.69% for the broad China index. Advancements in the IT sector have also led to the growth in the index weights of the Consumer Discretionary and Financial sectors. For example, digital wallets such as Alipay or Wechat Pay have become so popular in China, that instead of paying with cash or credit cards, consumers now use these mobile wallets to get lunch or to pay for rent, their utilities and taxis.

Sector Weights



Source: MSCI Inc. As of August 2017.

Top 10 Constituents	Float Adjusted Mkt Cap (USD bn.)	Index Weight (%)	Sector
TENCENT HOLDINGS LI (CN)	239.04	16.32	Info Tech
ALIBABA GROUP HLDG ADR	194.24	13.26	Info Tech
CHINA CONSTRUCTION BK H	73.76	5.04	Financials
CHINA MOBILE	65.14	4.45	Telecom Srvcs.
BAIDU ADR	62.32	4.26	Info Tech
ICBC H	55.24	3.77	Financials
BANK OF CHINA H	41.82	2.86	Financials
PING AN INSURANCE H	41.40	2.83	Financials
JD.COM ADR	27.49	1.88	Cons. Discr.
CHINA LIFE INSURANCE H	23.86	1.63	Financials
TOTAL	824.30	56.29	

Source: MSCI Inc. As of August 2017.
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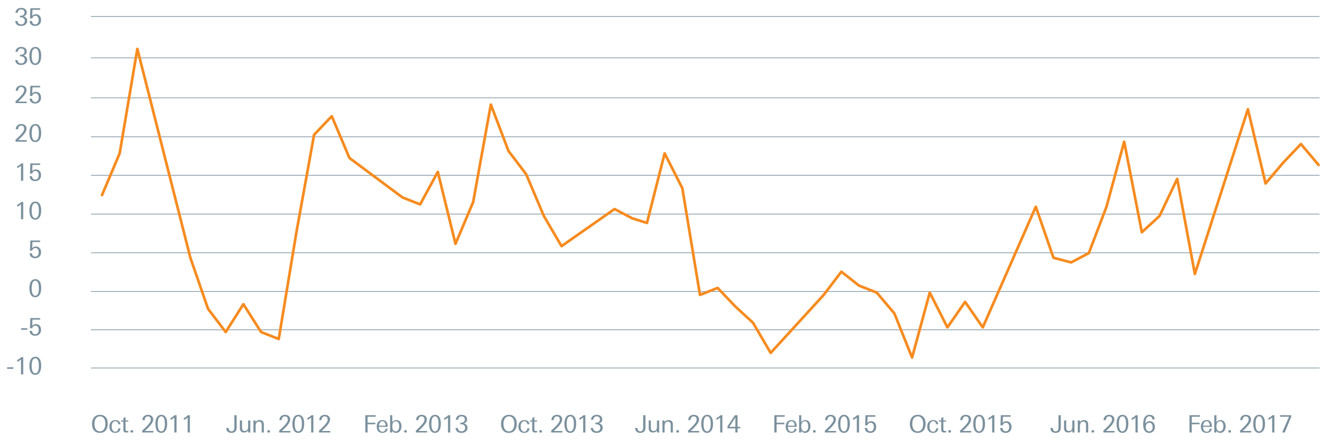
STRUCTURAL REFORMS AND INFRASTRUCTURE PROJECTS

SOE restructuring

As the economic growth outlook brightened in the spring, the government started to address the SOE problem by hiring private managers, allowing mixed SOE ownership and by closing inefficient SOEs. The result is more a more efficient SOE sector, which is partly reflected in the profit outlook for industrial companies.

Following strict SOE reforms, industrial profit growth (yoy, %) has reaccelerated

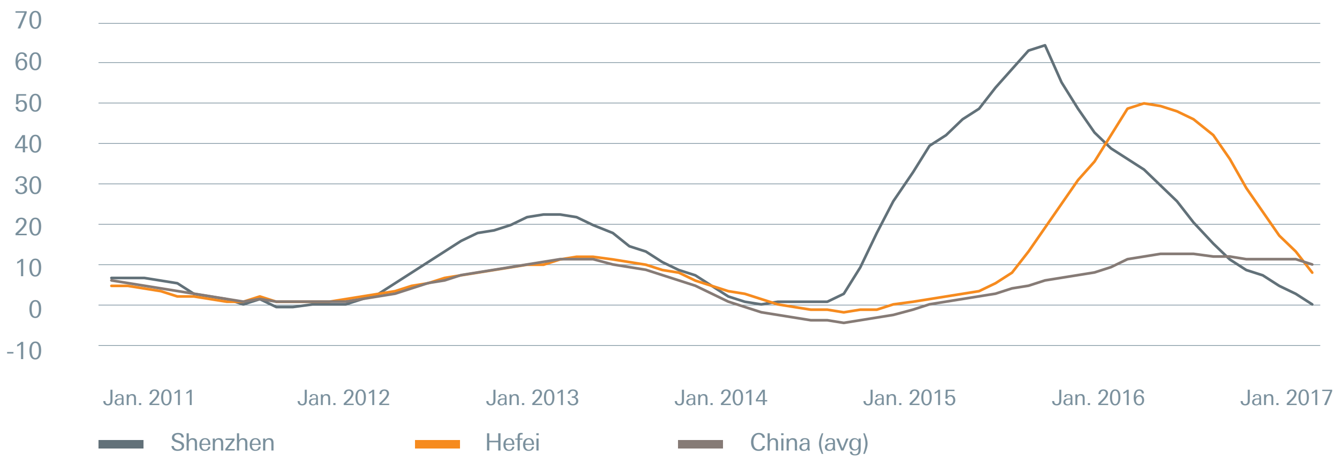


Source: Bloomberg Finance L.P., National Bureau of Statistics, as of July 2017.

Reducing Overleverage, Manufacturing overcapacity and housing supply

The secular demand for housing is still high in China due to continuing urbanisation (13 -15 million people per annum move to cities from rural areas) and ongoing demand for improved living standards. To prevent a housing bubble, since October 2016 both central and local governments have started to introduce restrictions on house purchases, which has led to a significant stabilisation in house prices.

Rebalancing underway: Property prices have stabilized in nearly all cities

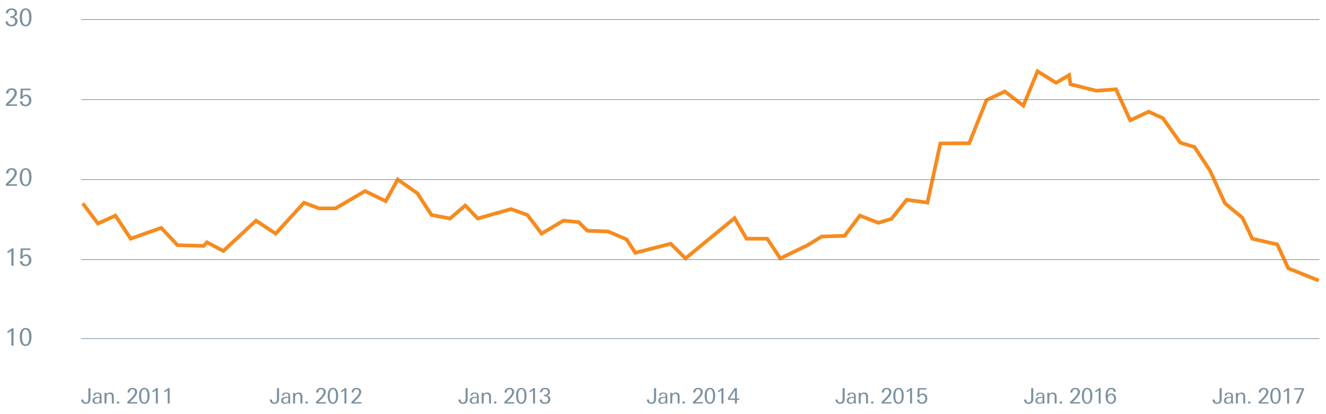


Source: Bloomberg Finance L.P., National Bureau of Statistics, year-on-year rate of property price increases (%) as of July 2017.

The house price bubble was caused not only by credit expansion, but also by speculative investors moving outside their central area of business. Since the beginning of this year, the PBoC has switched monetary policy into tightening mode to help deal with the economy's debt problem, signalled by a sharp rise in the 1-year inter-market interest rate. The central bank's overall goal is to reduce market liquidity by increasing money market rates and to tighten regulations on banks to reduce systemic leverage and risks.

As a result, bank credit growth has declined significantly during the last year (see the chart) and assets in so-called wealth management products have also decreased sharply. The PBoC is treading a fine line by trying simultaneously to deleverage the economy and to regulate certain new business areas without disturbing overall levels of investment. So far, it has been successful in its policy.

Bursting the bubble--bank credit growth (yoy, %)

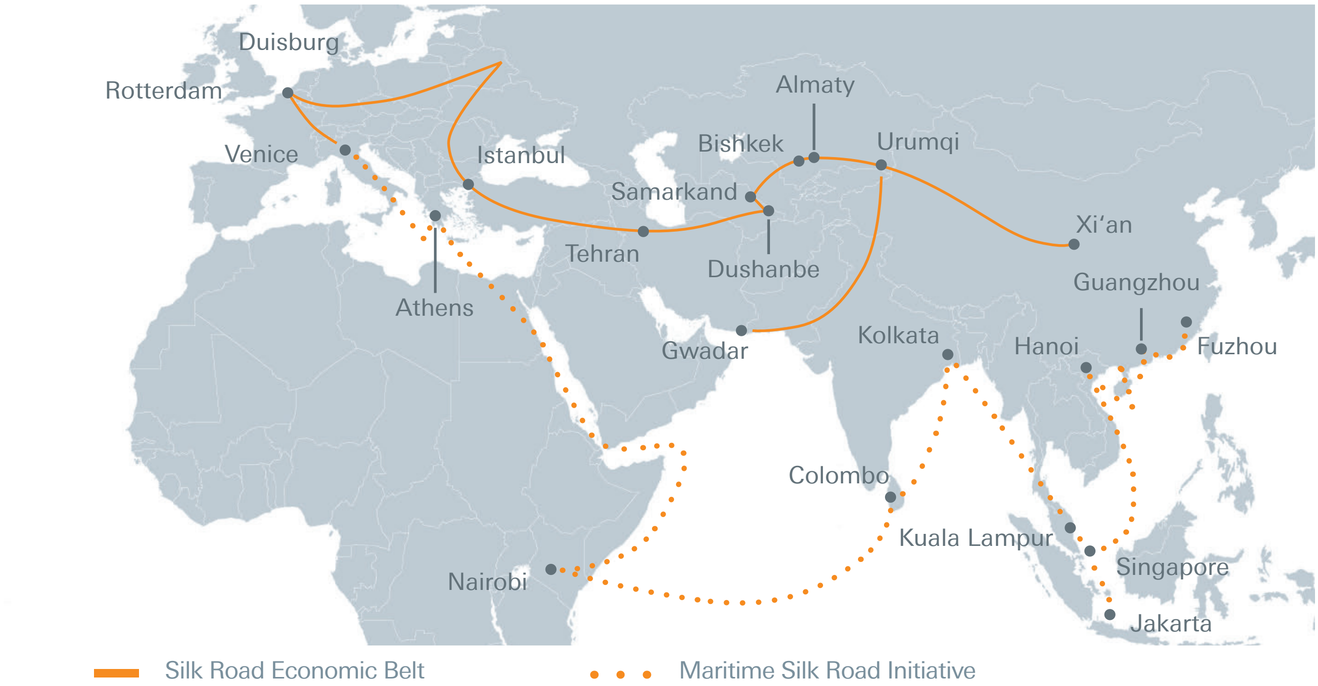


Source: Bloomberg Finance L.P., National Bureau of Statistics, PBoC, as of July 2017.

In last two years, China has closed about a quarter of its coal production capacity and several big steel and aluminium companies, which has led not only to better capacity utilisation rates, but also to a much better environment. Shipbuilding and (coal-based) electricity generation are two economic sectors with high levels of overcapacity that are due to be addressed next by the authorities. As the labour market is relatively sound, there has so far been limited resistance from the employee side to these attempts to cut overcapacity.

CHINA'S NEW SILK ROAD INITIATIVE COULD DRIVE FURTHER GROWTH IN TRADE AND EARNINGS IN THE YEARS AHEAD

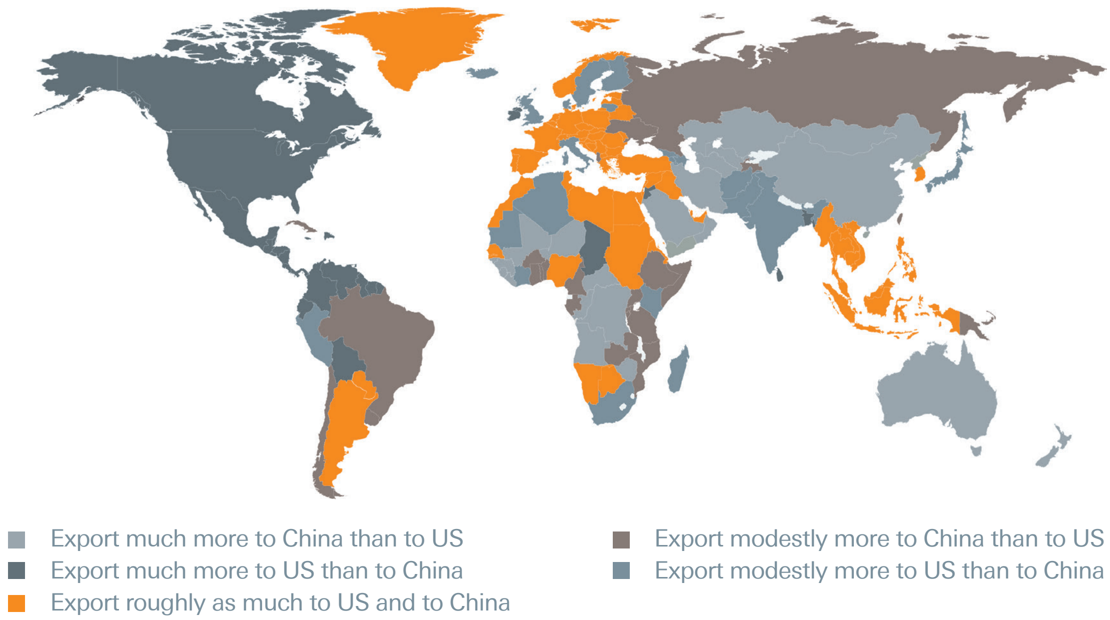
Taking inspiration from the ancient Silk Road trading route, China's One Belt One Road (OBOR) initiative hopes to link more than 65 countries, encompassing up to 40 percent of global GDP.



Source: Bloomberg Finance L.P., IMF, as of July 2017.

The OBOR initiative embeds two core economic policy objectives: one is to promote trade and the other is to promote development through cooperation on infrastructure projects.

Already, the impact of rising Chinese trade clout can be seen in a map of the world that highlights those countries that export mostly to the US (in blue) and to China (in red). Over the past decade, the red part has grown significantly, particularly across Europe and Africa.



Trade influence of China and the US in 2014. The colour shows how dependent each country's exports are on China relative to the US. For instance, countries in deep blue have the US surpassing China in terms of export market share by more than 10 percentage points.
Source: Deutsche Bank AG, China Customs, IMF, UN Comtrade as of May 2017.

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As of September 2017

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