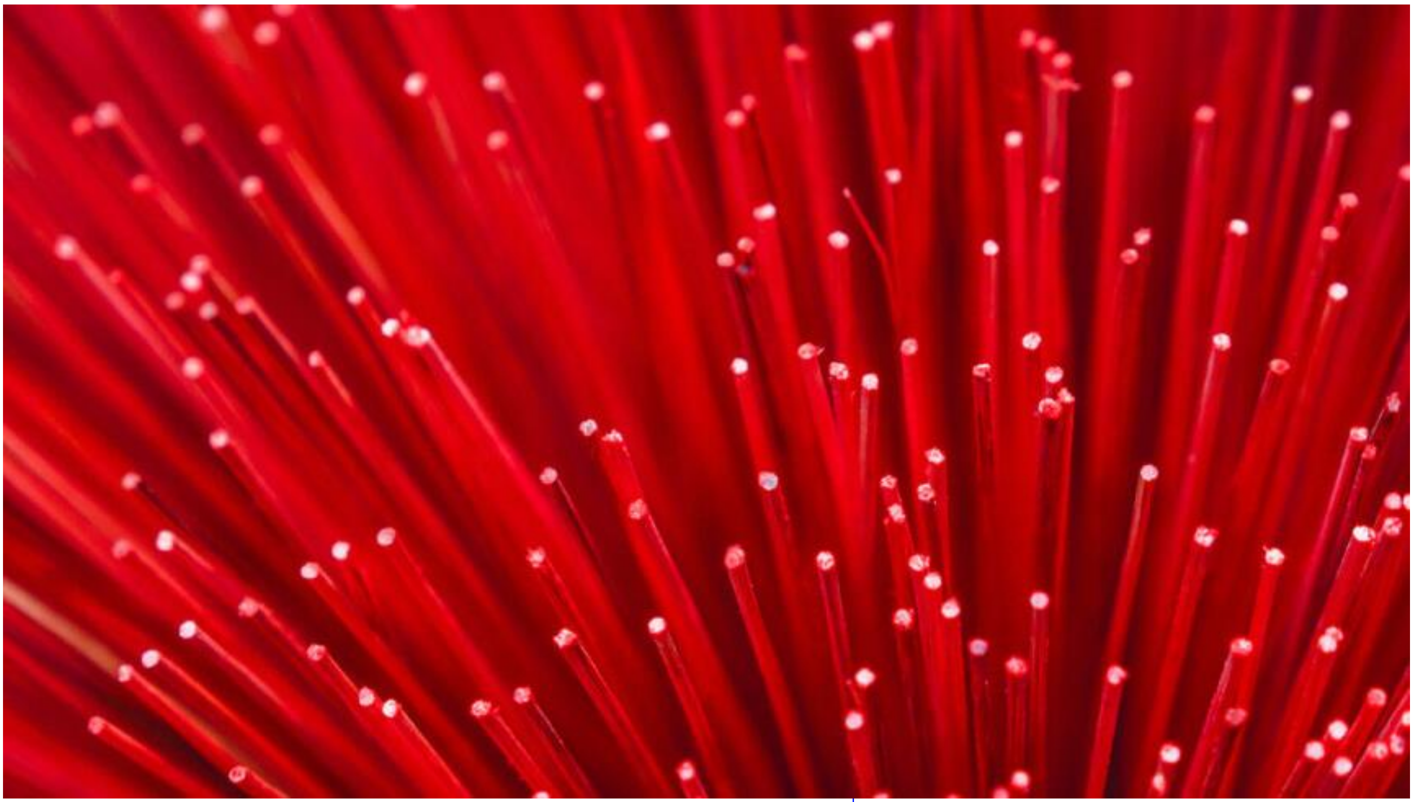

Global Investment Insights | Equities

China's evolving economy: a 20 year look back

Through the lens of the China A50 Index

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Overview

The FTSE China A50 Index was launched 20 years ago. The anniversary gives us the opportunity to think about how the A50 has changed in the last 20 years, and how those changes have mirrored changes in the Chinese economy. This paper highlights a few important changes in the industry classification weightings over time and ties them to important changes seen in the underlying economy. The representativeness of the index is important for investors seeking an efficient and liquid means of gaining exposure to the Chinese economy.

Contents

Introduction

The 20-year anniversary of the launching of the FTSE China A50 Index gives us the opportunity to look back and reflect on the fundamental changes that have occurred in the Chinese economy during this period. Among those changes is the growing importance of the equity market which has both given Chinese companies access to capital and given investors, foreign and domestic, access to the investment opportunities within China. This paper reviews the changes that we have seen in the Chinese economy and points out parallel changes in the FTSE China A50 Index. This connection between the economy and the index is important for investors who want an easily accessible instrument with which to gain exposure to investment opportunities in China.

The FTSE China A50 Index (or A50) was designed to give access to Chinese companies available to international investors. By constructing the index using the 50 largest A Share companies by full market capitalisation, the index represents an important composition of the local equity market. The A50 was launched in December 2003. Over the years, the A50 has evolved alongside with China's capital market development and international investors' need. Now all constituents in the A50 are subject to foreign ownership limits and sanctioned stock treatments and must be eligible under the Northbound Stock Connect program.

This paper focuses on the structure of the A50 by looking at the industry composition of the A50 and how it has changed over time. The industry classification system used is FTSE Russell's ICB system[1] which classifies stocks into 11 industries at the top level and has four levels of classification. We take advantage of the granularity of the ICB system to highlight important changes in the composition of the A50 over this period. The ICB analysis begins in June 2008 because the current ICB methodology was launched in 2019 with a 11-year history constructed from past records.

Rebalancing

The period of 2003-2023 was characterised by tremendous growth in the Chinese economy and equity market. When the A50 was launched, China accounted for only 8.6% of the global economic activity[2] and China account for only 0.15% of the market capitalization in the FTSE All-World Index. As of the most recent statistics, China accounts for over 18% of global GDP[3] and represented 3.4% of the FTSE All World index.

However, we will not focus on this growth in this paper but rather the changing characteristics of the Chinese economy and the parallel changes in the A50. While growth may attract the most investor attention, changing characteristics better explain the sustainability of this growth. More specifically the primary theme of change in the Chinese economy over the period was "rebalancing" which refers to the transformation of the Chinese economy that was intended to result in more sustainable growth. Many of the important components of rebalancing were policy-driven, but some were natural results of the evolution of the Chinese economy as it matured over this period.

One useful way to organise the concepts of Chinese economic rebalancing are laid out in the IMF's 2022 Staff Report[4] although the same organisation can be seen in many other IMF reports. While the IMF focuses on policy prescriptions, the organisation can be useful – it breaks the "rebalancing" process into four general categories:

- External: reducing the current account balance and the net export contribution to GDP
- Internal: increasing the consumption contribution to GDP relative to investment, increasing the consumption contribution to GDP relative to industrial (manufacturing?), and improving access to credit
- Environmental: improving energy efficiency and reducing air pollution

[1] FTSE Russell Industry Classification Benchmark (ICB) is described here: https://www.ftserussell.com/industry-classification-benchmark-icb

[2] Statista, China's share of global gross domestic product (GDP) 1980-2028

[3] IMF, GDP based on PPP, share of world

[4] IMF. 2022. People's Republic of China. Staff Report for the 2022 Article IV Consultation. p. 48.

- Income distribution: increasing labor income and reducing income inequality

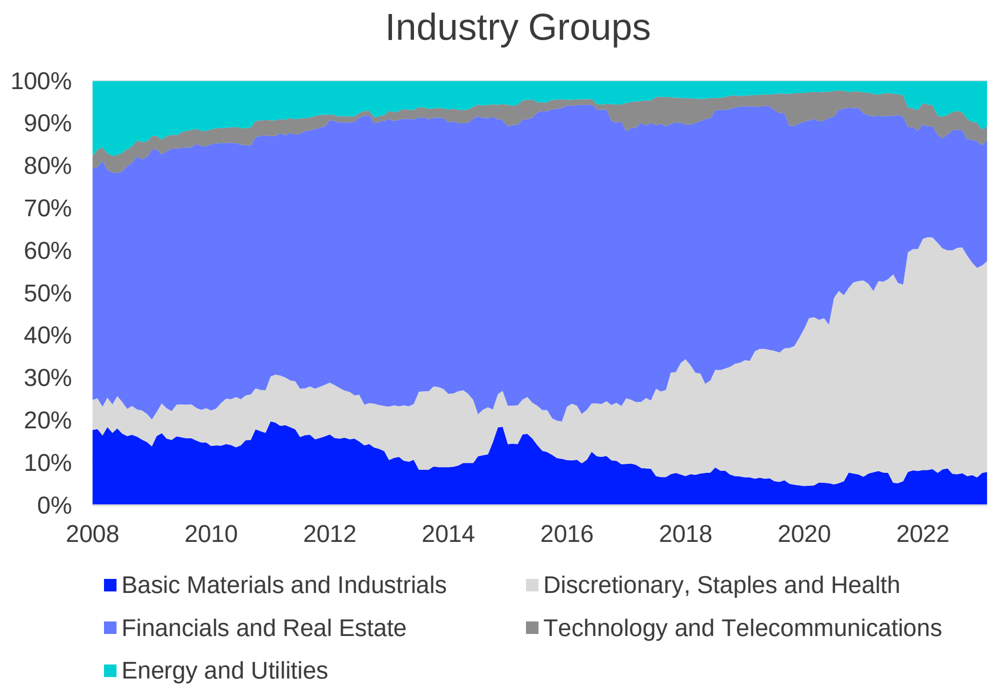
While these categories may seem clean-cut from a policy standpoint, it is important to note that there is considerable overlap between these categories when thinking about making economic growth more sustainable. For example, increasing the consumption contribution to GDP is expected to decrease net exports and so result in a drop in the current account balance. While reducing income inequality may be considered as a good policy on its own, stabilizing income for lower income consumers will also stabilise aggregate consumption, which will make the economy less susceptible to external export shocks.

Finally, while environmental goals may seem idealistic in some contexts, in China, environmental challenges have a direct impact on urbanization, household health, and cost of the government social safety net that impacts the savings and investment pattern driving economic growth. In our analysis below focusing on the FTSE A50, we combine the final income distribution category with the internal rebalancing section.

Chart 1 shows the weights of the 11 industries grouped into categories to give a high-level summary of the industry changes over time. This rough grouping reveals several of the most important changes over this period:

- Basic Materials, Energy, and Industrials are grouped together to combine the extractive industries and the main manufacturing industry (Industrials) to represent the export oriented economic industries at the beginning of the rebalancing period. This group has seen a steady decline from the first part of the data set until a recent increase in the COVID period.
- The two Consumer industries (Discretionary and Staples) are combined with the Health Care industry to represent the internal demand driven components of the equity market. This group has seen a significant expansion since 2016.
- Financials and Real Estate are grouped together to represent the components most related to the savings and investment dynamic of the economy. This group dominated the equity market early on and is still large but has “right-sized” as consumption has become a more important component of the economy.
- Technology and Telecommunications have not changed much in the A50 over this period, although as we will see, pervasive improvements in technology have been spread across the industries.
- Finally, Utilities used to support manufacturing early in the period dropped over the period until the resurgence during the COVID period.

Chart 1: FTSE China A50 Index industry groups' index weights over time



Source: FTSE Russell data, July 31, 2023

In the sections below we discuss the broad changes in the Chinese economy over the past 20 years and examine how these changes are reflected in the A50.

External rebalancing

Shift from exports to consumption

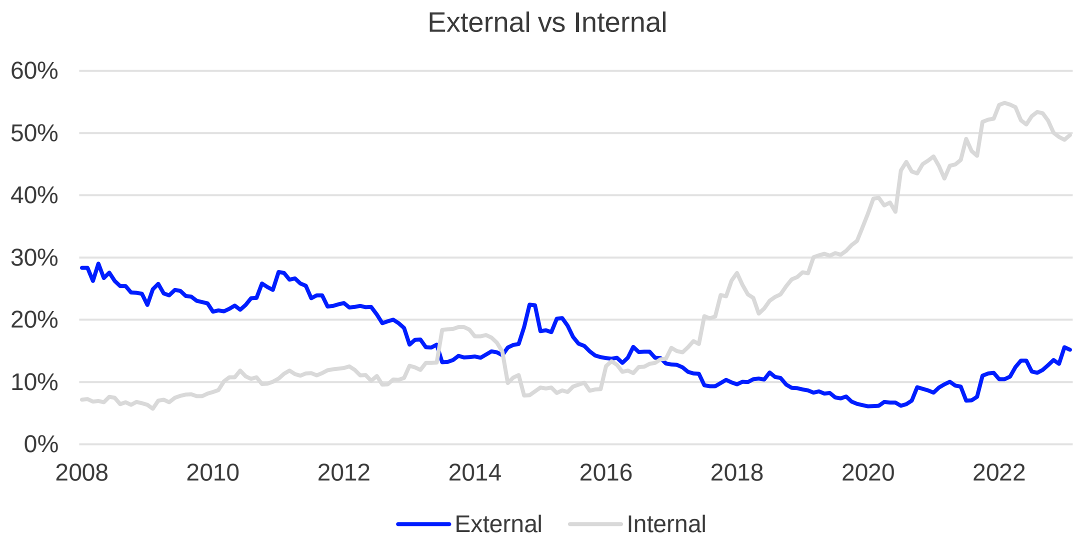
A primary goal of the Chinese government during this period was to shift the final demand of the economy from external demand to internal demand. While China had achieved tremendous growth with an export-led strategy, the goal was to put China on a more sustainable growth path. Export-led production is sensitive to foreign demand and trading frictions, including tariffs and exchange rate fluctuations. One simple policy prescription was to float the Chinese Yuan. While this was expected to worsen the terms of trade for China, it was intended to increase the purchasing power of Chinese households leading to a reduced current account balance and more consumption. Chart 2 shows that the Yuan did appreciate after currency controls were eased. While the exchange rate has drifted back up, the deregulation of the exchange rate was an important part in the economic rebalancing to come.

Chart 2: Exchange rate of Chinese Yuan to US dollar

Source: FTSE Russell data, July 31, 2023

Chart 3 shows six of the 11 industries organised into two groups representing the export production-oriented industries (Basic Materials, Energy, and Industrials) and more internal demand-oriented industries (Consumer Discretionary, Consumer Staples, and Health Care). These are the same groups as in Chart 1. At the beginning of the period, the export-oriented industries accounted for about 28% of the A50 and saw a slow but steady drop in weight until bottoming in June 2020 during the COVID crisis at about 6%. Since then, the weight has drifted up to about 15%, but as we will see below some of this is due to an increase in Energy production. On the other hand, the internal-demand group started at about 7% of the A50 and rose quickly after 2016 or so to finish the period at 50% of the index weight.

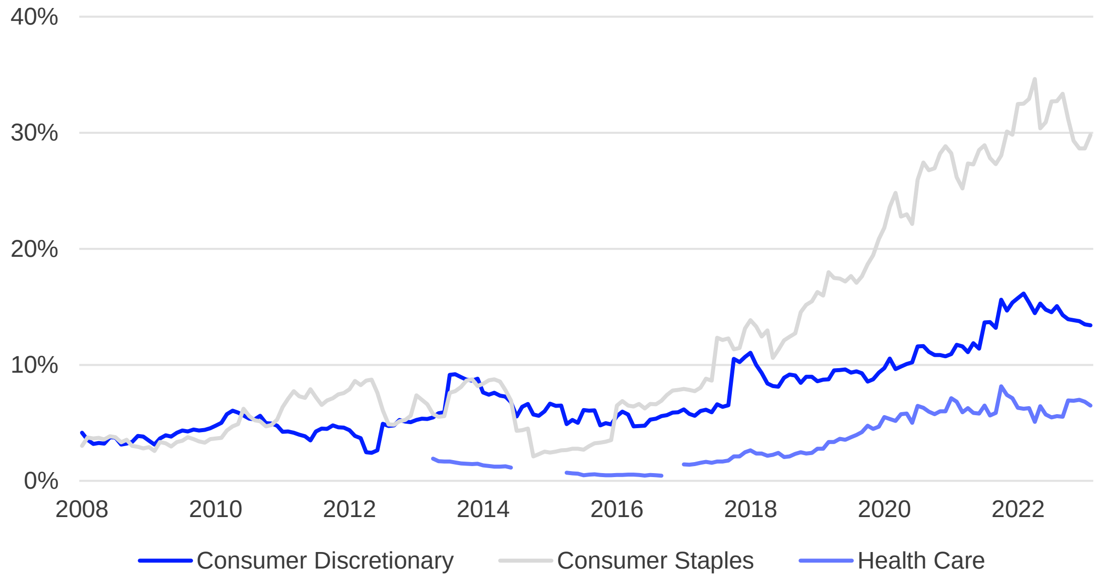
Chart 3: External vs Internal industry groups. FTSE China A50 industry group weights over time.



Source: FTSE Russell data, July 31, 2023

In Chart 4 we see that while all three industries in the Internal group increased their weights during this period, the bulk of the increase was in the Consumer Staples industry, and largely driven by the rise of beverage stocks such as Kweichow Moutai and Wuliangye Yibin. This was a period when there was rapid development of logistics of the consumption industries, for example with the development of e-commerce retail. However, the bulk of the change in industry weights was simply due to the rise in the middle class's disposable income which increased demands for domestic automobiles and appliances.

Chart 4: FTSE China A50 industry weights of Internal group



Source: FTSE Russell data, July 31, 2023

Internal rebalancing

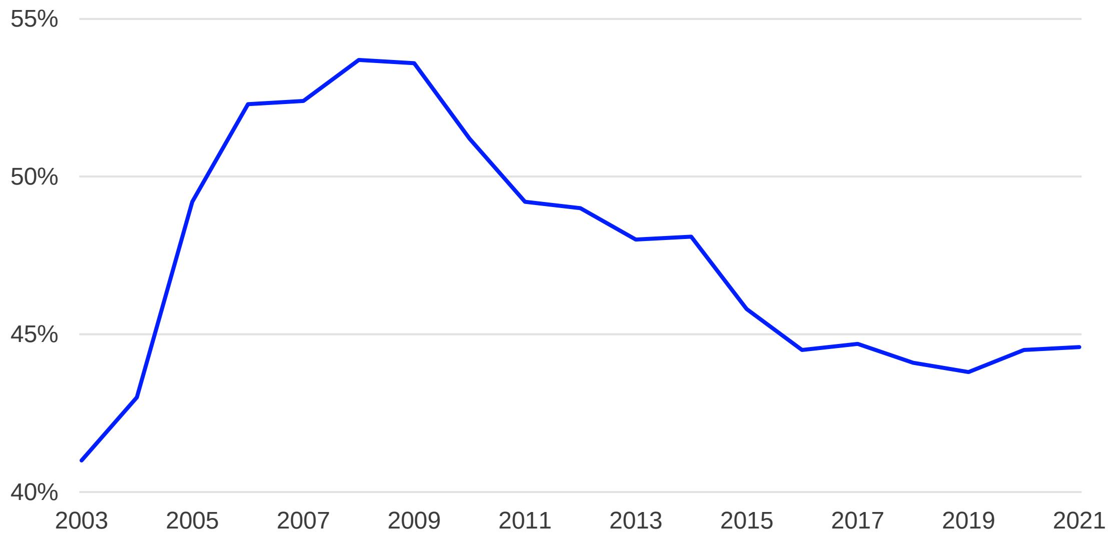
Consumption vs savings

The shift from external to internal orientation necessitated a fundamental change in spending patterns in the Chinese population that were impacted by multiple factors depending on both policies and expectations. The early growth periods were marked by very high savings rates with corresponding low rates of consumption, patterns driven by low availability of consumption goods and high precautionary savings habits caused by high uncertainty. Increasing consumption's share of GDP would require not only the development of consumption goods, but the increased willingness of the Chinese to spend their income on consumer goods. To accomplish the latter, the government needed to broaden consumer demand by ensuring income growth and reducing income inequality, and at the same time reduce the need for extraordinarily high precautionary savings rates by providing social security benefits such as access to health care and more efficient retirement income programs. These dynamics were affected by regulations on urbanization, finance, and housing.

Savings

The shift from external to internal demand required a shift in Chinese households from savings to consumption. Chart 5 shows that official savings as a percentage of GDP was quite high in the mid-2000s and then dropped gradually during the 2010s, although it remained quite high. The desire to save is driven by a number of factors include personal preferences, but a primary factor is the desire for precautionary savings due to uncertainty over future income -- the more uncertainty the higher precautionary savings. One policy theme was to reduce uncertainty by providing a better social safety net, including higher income growth, better health care, and more assured retirement income.

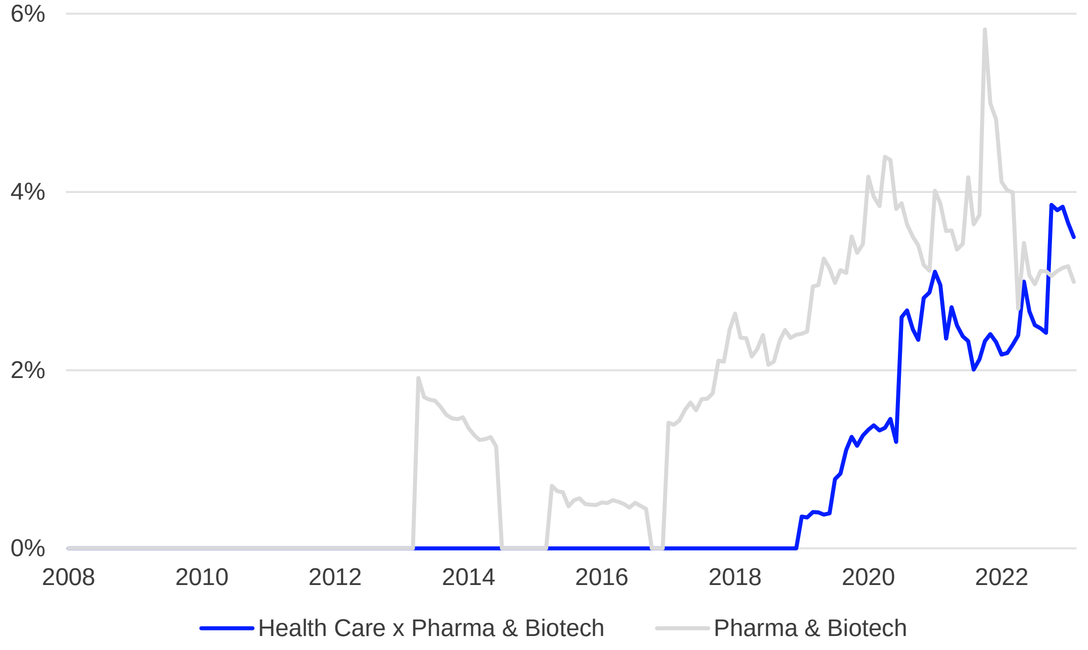
Chart 5: China national savings as percentage of GDP



Source: FTSE Russell data, July 31, 2023

One indication of the improved social safety net seen through the lens of the A50 is the increased weight in the Health Care industry. Representation of the Health Care industry within the A50 has increased relatively quickly since 2017. While growth of the Pharmaceutical & Biotech sector has been impressive (see Chart 6), also important is the recent growth in the rest of the industry, which is composed of Health Care Providers and Medical Equipment and Services. This growth in a more diversified Health Care industry likely reflects increased demand from an aging population.

Chart 6: FTSE China A50 Health Care industry weights: Pharmaceuticals & Biotech vs the rest



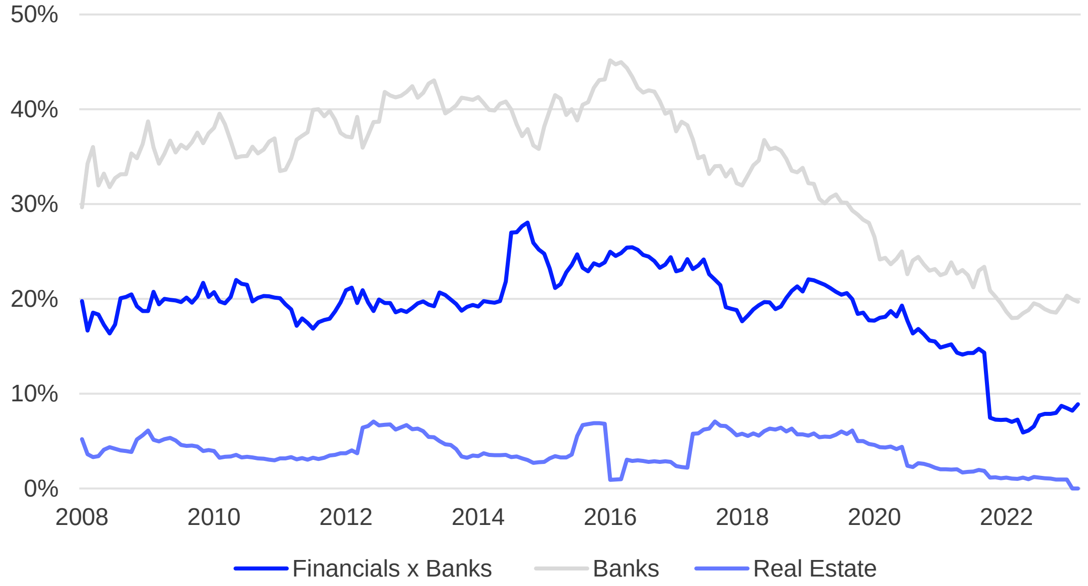
Source: FTSE Russell data, July 31, 2023

Financial system

The final part of the rebalancing transformation focuses on the financial system. This discussion is intertwined with the discussion of savings because the high savings rate pushed capital into various component of the financial system. In Chart 1, we combined the Financials and Real Estate industries and showed that they had a majority of the weight in the A50 index at the beginning of the period, but their combined weight had dropped by about half by the end of the period.

The high weight in Financials is not unusual for Emerging Markets, particularly because that industry is well-integrated into the financial markets (by definition!). In the case of the A50, the increasing returns to scale of banks natural led to a high representation of banks in the largest 50 stocks in the equity market. Chart 7 illustrates that banks have been the largest part of the Financials industry in the A50. In both banking and non-bank financials, however, there has been a marked decline in index weight since 2016, which roughly coincides with the rapid increase in weight in consumer related industries.

Chart 7: FTSE China A50 Financials and Real Estate weights



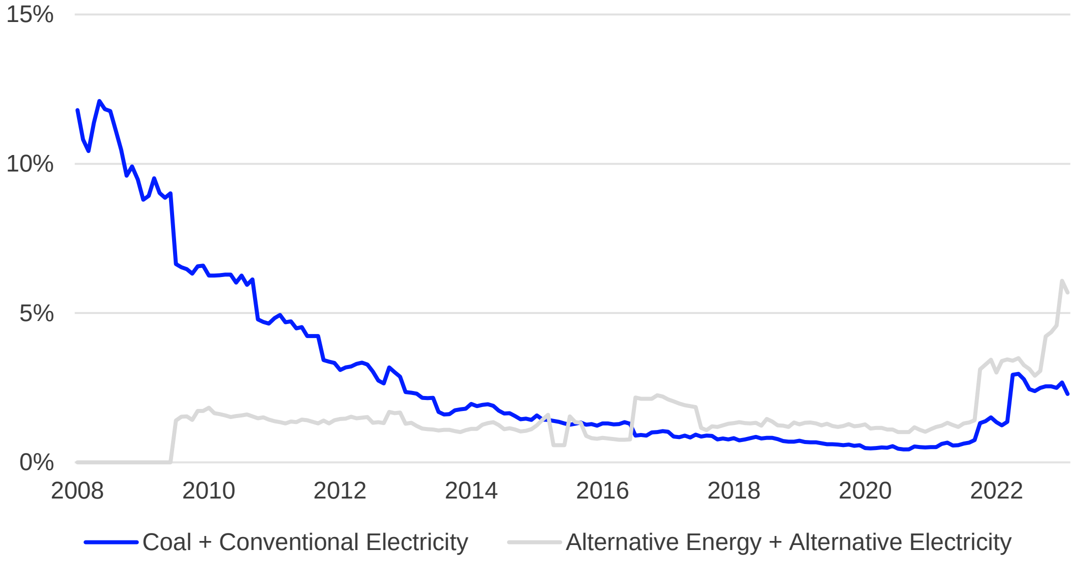
Source: FTSE Russell data, July 31, 2023

The Real Estate industry has also played an essential role in the Chinese economy. With precautionary savings rates high and deposit interest rates capped in China many Chinese households bought real estate as a store of value, an investment, and a hedge against the uncertain housing supply for their families. While the intricacies of the Chinese real estate market are outside the scope of this paper, we can see that the weight of the Real Estate industry within the top 50 stocks represented in the A50 has decline recently along with the decrease in Financials stocks.

Environmental

In this last section we point out a small portion of the A50 that is growing in importance, which is the alternative energy section. The adoption of alternative energy is important for China both for household health reasons and growth robustness reasons. Rapid growth in China has led to pollution spikes, but adoption of low carbon alternative has also been quite high. One way this transition is reflected in the A50 is in the weights of the components of the Energy and Utilities industries at the more granular sector and sub-sector ICB level. Chart 8 shows the rapid decline of the Coal and Conventional Electricity subsectors and compares them to the Alternative Energy sector combined with the Alternative Electricity subsector. Recent data shows a rapid increase in the weight of the Alternative Energy representation. The jump in coal and conventional electricity generation coincides with the spike in energy prices after start of the war in Ukraine when energy supplies dropped and many countries reverted to using coal, a pattern that was seen globally.

Chart 8: FTSE China A50 conventional vs alternative energy weights



Source: FTSE Russell data, July 31, 2023

Three examples of this greening of technology in China are Contemporary Amperex Technology, BYD, and LONGi Green Energy Technology. Contemporary Amperex Technology is a battery manufacturer that provides batteries for electric vehicles and energy storage systems. It is in the Automobile and Parts sector of the Consumer Discretionary industry and currently has the second largest weight in the A50. BYD is perhaps best known for building electronic vehicles, but also produces rechargeable batteries and solar panels. BYD currently has a weight of approximately 3.15% in the A50 and is also in the Automobile and Parts sector. LONGi Green Energy Technology is a photovoltaics company that is contributing to the production and improvement of green energy generation. It has a weight of about 1.45% in the A50 and is in the Alternative Energy sector of the Energy Industry. These companies show that technological improvements are moving Chinese production away from the low-cost exports that spurred early growth to higher value-added exports that are also be consumed and used within the Chinese economy.

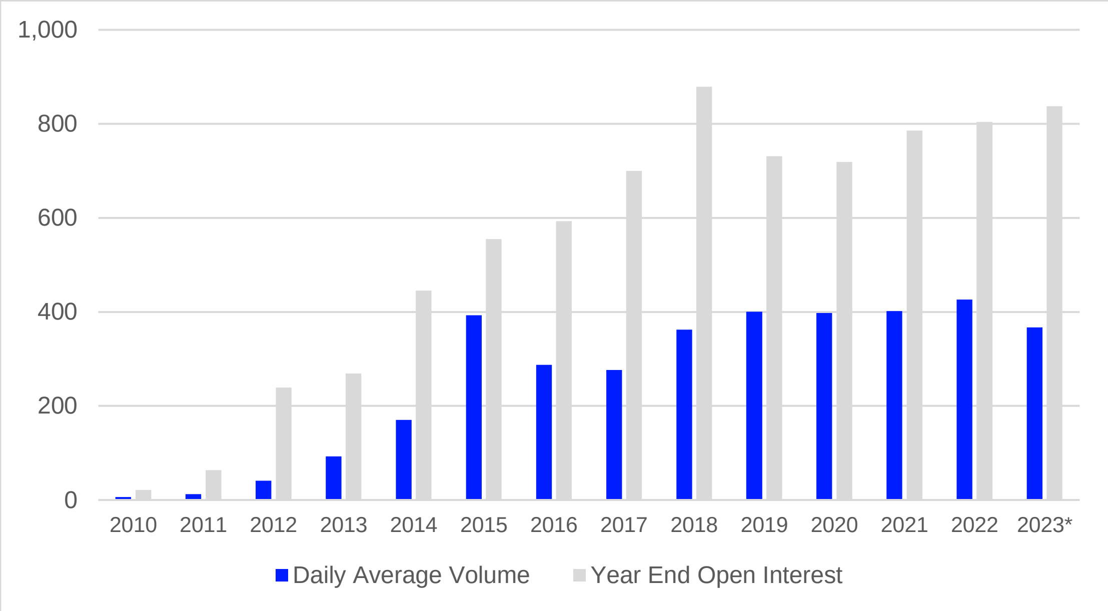
Accessing FTSE China A50 with derivatives

The Chinese economy has been through significant change in the last 20 years, driven by policy objectives as well as the natural evolution of the market. The equity market has seen parallel changes both as Chinese financial markets have deepened and as equity markets have reflected the changes in the underlying economy.

One of the most efficient methods for foreign investors to access the local equity market is through investment vehicles that track the FTSE China A50 Index, which has evolved in parallel to the important transitions seen in the Chinese economy.

Launched in 2006, the SGX FTSE China A50 index future is the most liquid offshore A-share index future. Its hyper liquidity has attracted a diversity of global investors with different trading styles and duration. The average daily volume and open interest, which was only US$50 million and US$200 million respectively by the end 2010, reached US$4 billion and US$10.5 billion respectively in November 2023 (see Chart 9).

Chart 9: SGX A50 Index future daily average volume and year-end open interest (in ’000 lots)



Source: SGX data, November 30, 2023

This contract trades 20 hours a day covering Asia, Europe and US trading hours. The average bid-offer spread is as tight as 1 bp regardless of whether it is during a day or night session. An important feature of the SGX FTSE China A50 Index Futures is the availability of trading when the underlying cash market is closed. This contract is available for trading every weekday other than New Year’s Day. During the last China’s Golden Week holiday in October, SGX FTSE China A50 Index futures traded on average 95k contracts daily (US$1.2B), garnering an 87% market share of the off-shore A-share index futures market.

The extensive coverage and deep liquidity of this contract allows global investors to manage their risks in a timely manner and to express views on the market round the clock.

Final remarks

Looking ahead, it will be interesting to continue tracking China’s evolving economy as the country gradually pivots away from lost-cost exports towards providing high value-adding services and the effect of this to the global economy.

The FTSE China A50 Index will also continue to evolve and reflect the changes in the underlying economy and the SGX FTSE China A50 Index Futures will remain an instrumental tool for global market participants to access China.

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